Management Report

Macroeconomic Environment

HIGHLIGHTS

01 In 2011, the combined effect of macroeconomic shocks and dysfunction in certain political institutions weighed heavily on the global economy and returns on riskier assets.

02 The sovereign debt crisis in Europe threatened its banking system and the survival of the euro.

03 Many central banks responded to the deteriorating outlook by easing monetary policy and keeping interest rates at historically low levels.

04 Québec's economy was also exposed to global macroeconomic shocks in 2011; however, international exports showed encouraging signs toward year end.

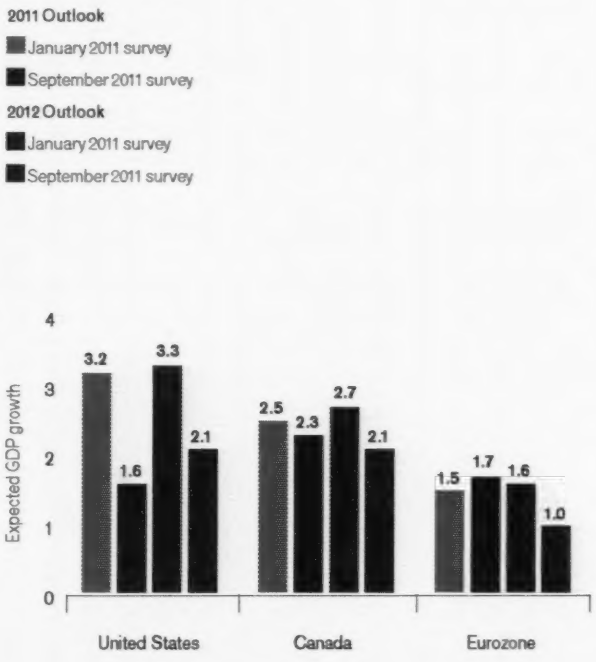
The year began on a positive note, driven by monetary and budgetary stimulus measures announced in the United States at the end of the previous year. The economic outlook in the developed countries appeared encouraging. However, several major macroeconomic shocks served as a reminder that the global economy was still vulnerable in the wake of the financial crisis, in particular due to the high levels of household and government debt in the developed world.

In early March, the earthquake and tsunami in Japan disrupted industrial supply chains around the world, sending Japan into recession and slowing global growth. Again in March, a series of uprisings in the Arab world drove up energy prices, reducing the purchasing power of consumers everywhere. In July, despite evidence that the U.S. economy had entered an expansionary phase at the end of 2010, a major downward revision to GDP data effectively downgraded this expansion to a mere recovery. Then, in August, rating agency Standard & Poor's downgraded the United States' credit rating, from AAA to AA+, stating that Congress had not agreed on a credible plan to reduce the national debt in the medium term.

The combined effect of these events was that economists were obliged to lower their growth outlooks considerably (see Figure 4), which resulted in much more risk aversion. Stock prices dropped abruptly, and interest rates fell to historically low levels (see Figure 5, p.19).

FIGURE 4

DETERIORATING ECONOMIC OUTLOOK BETWEEN JANUARY AND SEPTEMBER 2011
(as a percentage)



Source: Data from surveys carried out by Consensus Economics with the world's leading forecasters.

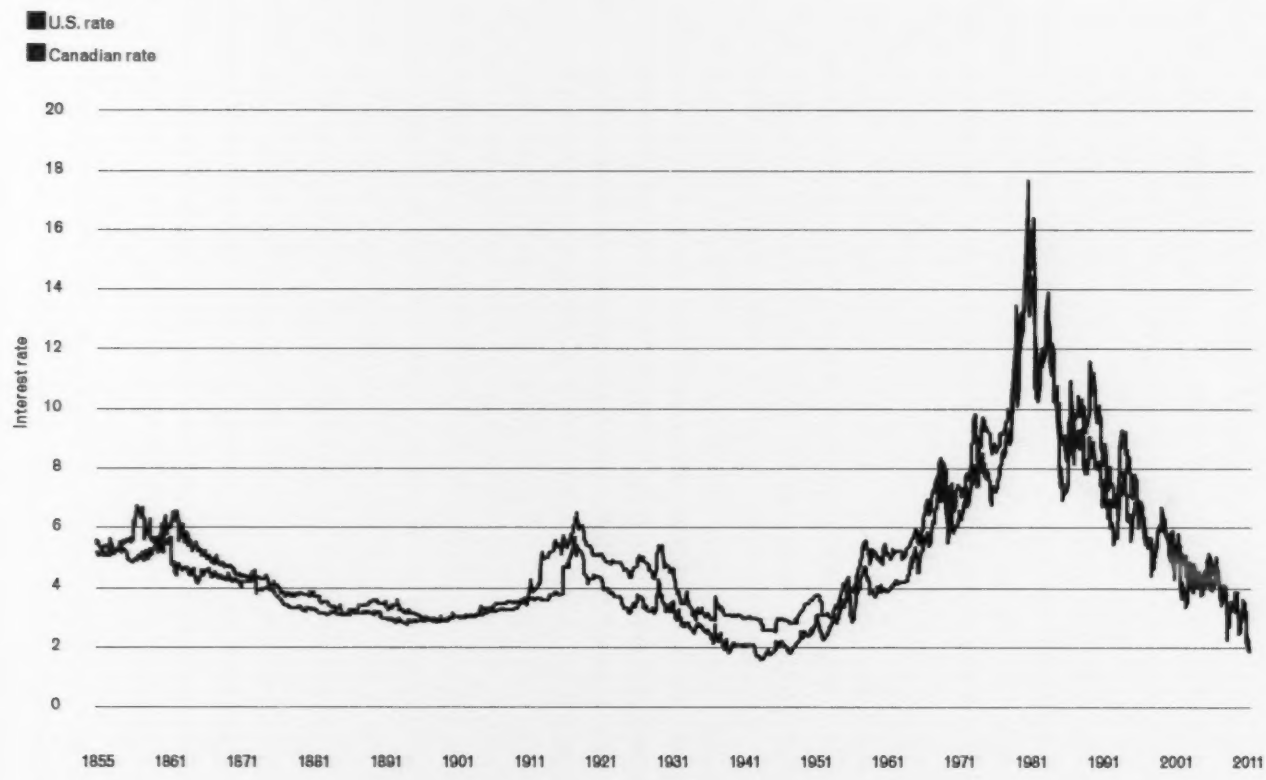
The sovereign debt crisis in Europe also played a major role in darkening the global economic outlook and creating a climate of uncertainty. Households and businesses in the eurozone cut spending as a result of the budget austerity measures implemented by their governments. These measures notwithstanding, the cost of financing most of the heavily indebted countries (Greece, Portugal, Spain and Italy) continued to rise, and a series of downgrades followed. Since most of these countries' bonds are held by European banks, rising bond interest rates eroded their assets and raised their borrowing rates.

They then passed this increase along to clients, including households and businesses, in the form of higher borrowing costs and tighter credit conditions, which further held back growth. Finally, given the close financial ties between the indebted countries, European banks and the European economy, the climate of uncertainty was exacerbated by fears that a series of disorderly defaults would threaten not only growth in the eurozone, but also the solvency of the European banking system and even the euro itself.

FIGURE 6

EVOLUTION OF INTEREST RATES OF 10-YEAR BONDS OF CANADIAN AND U.S. GOVERNMENTS (1855-2011)

(as a percentage)



Sources: Economic Analysis and Asset Allocation Strategies (Caisse), Global Financial Data, Bloomberg

Macroeconomic Environment

In this environment, the main central banks decided to ease monetary policy. In anticipation of a low use of resources and controlled inflation, the U.S. Federal Reserve (the Fed) committed conditionally to maintaining its key interest rate at a very low level until mid-2013 and extended the average maturity of its bond portfolio to exert additional downward pressure on long-term interest rates. In November, the European Central Bank (ECB) lowered its key interest rate by 25 b.p. (0.25%). It lowered the rate again in December, in addition to adopting an extraordinary measure to support European banks and interbank lending. This prevented a liquidity crisis and reduced the funding costs of some indebted countries. As for the emerging economies, China was forced to tighten monetary policy during 2011, only to begin easing at the end of the year to counter the effects of a slower global economy and to prevent economic activity in China from slowing down too quickly. The Central Bank of Brazil also lowered interest rates.

In financial markets, asset returns rose and fell as investor sentiment cycled between risk aversion, in response to macroeconomic shocks, and a greater appetite for risk, as central banks and governments waged counter-attacks to diminish their effects. In the end, the reasons for seeking capital protection dominated. Despite growing earnings posted by listed companies, the stock markets of the main developed countries ended the year in negative territory, except for the S&P 500, which posted a 2.1%[1] gain. In contrast, it was an excellent year for bond markets, with the notable exception of bonds of the troubled European countries.

Canada

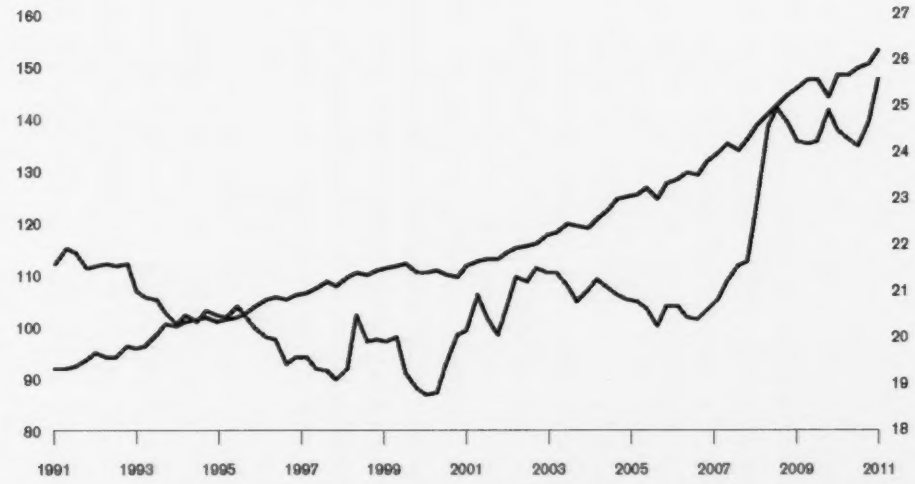
GDP growth in Canada slowed substantially, from 3.2% in 2010 to 2.5% in 2011, mainly due to slower growth in domestic demand. While exports rose and fell in response to the various global macroeconomic shocks, the erosion of purchasing power caused by higher oil prices and declining household confidence together limited consumption growth, which fell from 3.3% in 2010 to 2.2% in 2011. The labour market, which was strong at the start of the year, had weakened somewhat by the fourth quarter, with the unemployment rate reaching 7.5% by year end. Private non-residential investment (+13.7% in 2011) grew strongly early in the year owing to the financial health of businesses, the strength of the Canadian dollar and favourable credit conditions. Even so, external macroeconomic shocks diminished the sales outlook for businesses, such that investments in machinery and equipment posted an 11.8% annualized decline in the third quarter and a slight 2.7% increase in the fourth quarter. Finally, the debt burden of Canadian households continued to rise in 2011, particularly through mortgage loans. By the end of 2011 household debt had reached more than 150% of disposable income (see Figure 6).

1. Given the depreciation of the Canadian dollar, the return translated into Canadian dollars was 4.6%.

FIGURE 6

HOUSEHOLD DEBT IN CANADA

(as a percentage)



Sources: Economic Analysis and Asset Allocation Strategies (Caisse), Statistics Canada

Québec

Like almost all the developed countries, Québec's GDP growth slowed during the year, from 2.5% in 2010 to 1.7% in 2011. This slowdown was caused by a marked decline in the growth of domestic demand in an environment where several adverse external shocks affected foreign trade, particularly in the first half of the year. The slowdown was due in large part to the near stagnation of consumer spending in the first three quarters of the year, and to increased inflation, which had a marked effect on household purchasing power. The residential sector also weighed on domestic demand, as housing starts fell 5.8% compared to 2010. That being said, domestic demand benefited from the financial health of private businesses, which increased investments in machinery and equipment.

The strength of the Canadian dollar put pressure on the manufacturing sector, which declined by 0.3%. The aerospace industry again lost ground (-1.1%), despite a slight rebound in the second half of the year. The service sector continued to contribute to growth (+1.9%), despite a 0.4% decline in the retail industry.

Finally, the end of 2011 was characterized by mixed signals. The employment market gave cause for concern in the fourth quarter when the unemployment rate rose. However, a second survey, conducted in companies, indicated that jobs were created in the same period. This trend appears to be continuing, with a decrease in the unemployment rate in the first quarter of 2012. Several important economic indicators also gave encouraging news during the final months of the year, notably real global exports of goods and services, which grew at a 21.1% annualized rate in the fourth quarter.

United States

The U.S. economy grew 1.7% on average in 2011, significantly below the 3% growth recorded in 2010. At the beginning of the year, economic forecasters were projecting 3.2% growth, but the macroeconomic shocks in the first half and the deepening sovereign debt crisis in Europe revealed the extent to which the 2008 financial crisis had weakened the U.S. economy. Concerned about this situation, the Fed responded by easing monetary policy aggressively. In August, the Fed committed to maintaining its key interest rate at a very low level until mid-2013, provided that inflation remained under control and the resource utilization rate stayed low. In September, as part of a program called Operation Twist, it also extended the average maturity of its bond portfolio. By exerting this kind of pressure to lower interest rates, the Fed is trying to create a growth dynamic for the U.S. economy so that it will be strong enough to absorb the impact of consumer debt reduction and a potential tightening of fiscal policy after the presidential election.

In the real estate market, housing starts increased, but only in the multiresidential sector. While inventories of houses for sale have declined slightly, they remain high and are even higher once data is included on properties that are in default but that banks are keeping off the market for fear of driving prices down even further. The labour market had a better year: the unemployment rate fell from 9.4% at the end of 2010 to 8.5% one year later, with 1.8 million jobs created in 2011, compared to 1.0 million jobs in 2010. Despite these gains, real personal disposable income grew only 1.3%. In fact, the great majority of the benefits of economic growth went to businesses, with the profit-to-GDP ratio reaching a record 13%. Despite this profitability, the ratio of investments as a percentage of profits dropped to a 40-year low. Given consumers' debt reduction and the prospect of fiscal austerity, businesses turned to other strategies, such as share buybacks and higher dividends.

Eurozone

Economic activity in the eurozone grew 1.5% in 2011, compared to 1.9% in 2010. Eight of the 17 eurozone countries slipped into recession in the second half of 2011. Apart from a particularly difficult international economic environment, the deteriorating situation in the region was due mainly to a deepening sovereign debt crisis. This situation forced several countries to implement additional fiscal austerity measures to try to bring their debt levels down to more sustainable levels. Since the economic indicators continued to deteriorate, in the spring, financial markets began to have serious doubts about the sustainability of debt levels in several heavily indebted countries. As a result, the borrowing costs of these countries and of private European banks rose sharply, prompting the ECB to intervene on several fronts in an attempt to calm the financial markets. As part of the Securities Markets Programme launched in 2010, it continued to buy the bonds of sovereign countries on the secondary market. Then, in November, it lowered its key interest rate by 25 b.p. (0.25%). It did the same in December, in addition to announcing extraordinary measures to support European bank and interbank lending. It gave financial institutions access to an unlimited amount of funding at a low interest rate, it expanded the universe of securities that can be given as collateral for the loans it grants to banks and it lowered the required reserve ratio from 2% to 1%.

Macroeconomic Environment

Japan
The earthquake and tsunami of March 11 practically destroyed northeastern Japan and took the lives of over 15,000 people. It also caused GDP to fall 0.7% in 2011. The export sector was hit especially hard, with Japan recording a negative trade balance, its first since 1980. Imports surged as the country set about rebuilding and began purchasing abroad goods that had previously been produced in the devastated region. Imports of natural gas jumped to fuel power plants that had been brought online after the shutdown of many nuclear plants. As for exports, the Japanese had to deal with a rising yen in a difficult global environment.

Emerging economies
After reaching 8.1% in 2010, real GDP growth in the emerging Asian economies[1] slowed to 6.5% in 2011. Many of these countries had faced rising inflation in 2010, mainly because of overheated economies; consequently Asian monetary authorities raised their key interest rates and tightened credit conditions to slow economic growth to a more sustainable level.

In China, economic growth fell from 10.4% in 2010 to 9.2% in 2011. In Brazil, economic growth slowed even more, to 2.7% in 2011 compared to 7.5% one year earlier. In India, households were hit especially hard by higher food and energy prices at the start of the year. Economic growth slowed to 7.1%, compared to 8.5% in 2010.

In fact, the combined effects of macroeconomic shocks around the world and monetary tightening finally slowed economic growth somewhat more than was initially expected in some countries. This situation prompted the monetary authorities in China and Brazil to begin reversing their tightening policies. In contrast, at the end of 2011 India was maintaining a policy of monetary tightening since inflationary pressures remained high.

WHAT IS IN STORE FOR 2012?

Our analyses suggest that in 2012 the global economy will continue to suffer from the consequences of the financial crisis, and that most developed economies will continue to repair their balance sheets. History shows that financial crises are followed by many years of balance-sheet deleveraging. The result is weak economic growth.

In Canada, economic growth will be undermined by the slow recoveries of our main trading partners, mainly the U.S. and Europe, as well as a strong Canadian dollar and household balance sheet deleveraging. The outcome will be slower growth in consumption and less activity in the residential real estate sector. GDP growth should therefore be under 2% in 2012.

In Québec, GDP growth should be lower – approximately 1.5% – while the manufacturing sector will most likely continue to be penalized by the strength of the Canadian dollar. Inflation in Canada should fall to 1.7% by the end of the year, but changes in the price of crude oil could derail this forecast, particularly in the event of open conflict in the Middle East.

After having gone through a period rife with uncertainty in mid-2011, the U.S. economy should continue growing in 2012, sustained by gradual improvements in the labour market, healthier banks and rising consumer credit. GDP growth should therefore accelerate slightly, to around 2%.

Europe, which entered a recession in 2011 mainly due to tighter fiscal policies in the indebted countries, may not see growth again until the end of 2012 or the beginning of 2013. Furthermore, in all likelihood any recovery will be modest. Greece's structural problems have not yet been resolved, but the measures announced by the ECB should prevent contagion in the other countries that are in trouble as long as their governments implement credible reforms.

The emerging economies should be able to maintain growth rates near their potential GDP, making use of their monetary and fiscal leeway, as necessary.

1. We consider the following emerging economies to be part of emerging Asia: China, Hong Kong, India, Indonesia, South Korea, Malaysia, the Philippines, Thailand, Taiwan and Singapore.

Overall Portfolio

HIGHLIGHTS

01 The 17 specialized portfolios available to depositors are grouped together into four categories that are representative of the risk-return profile.

02 Eleven specialized portfolios are actively managed and six others are indexed.

03 In 2011, the Caisse reduced its equity exposure and increased its positions in inflation-sensitive investments.

04 As at December 31, 2011, the proportion of total assets invested in Canada stood at 59.6%.

The Caisse offers depositors the ability to allocate their funds across various specialized portfolios, each consisting of securities from one asset class. An investment policy sets out the management approach and parameters for each portfolio regarding its investment universe, benchmark index, performance and value-added objectives (in the case of an actively managed portfolio) – in addition to risk monitoring with clearly defined concentration and risk limits.

SPECIALIZED PORTFOLIOS

As at December 31, 2011, the Caisse offered its depositors 17 specialized portfolios split into four broad risk-return profile asset classes (see Table 7):

- The **Fixed Income asset class** reduces the portfolio's overall risk level and helps match depositors' assets to liabilities. It comprises four portfolios.
- The **Inflation-Sensitive Investments asset class** provides exposure to markets whose income is generally indexed to inflation. This can partly hedge against the inflation risk associated with the liabilities of many depositors. It comprises three portfolios.
- The **Equity asset class** essentially enhances the expected long-term returns of depositors. It comprises seven portfolios.
- The **Other Investments asset class** comprises three portfolios.

Active management and indexed management
Eleven of the 17 specialized portfolios, representing approximately 78% of net assets, are actively managed and offer the possibility of generating value added. The other six portfolios are index-managed, replicating market indexes. While focusing its efforts on active management of portfolios where it has comparative advantages, the Caisse offers depositors the opportunity to choose between actively managed or indexed international equity portfolios.

TABLE 7

SPECIALIZED PORTFOLIO OFFERING
(as at December 31, 2011)

	ACTIVELY MANAGED	INDEXED
Fixed Income	Bonds Real Estate Debt	Short Term Investments Long Term Bonds
Inflation-Sensitive Investments	Infrastructure Real Estate	Real Return Bonds
Equity	Canadian Equity Global Equity Québec International Private Equity	U.S. Equity EAFE Equity Emerging Markets Equity
Other Investments	Hedge Funds Asset Allocation ABTN	

Overall Portfolio

INVESTMENT PHILOSOPHY

The Caisse invests the funds of its clients, the depositors. Its goal is to provide them with long-term returns, while taking into account their risk tolerance and the nature of their liabilities. In carrying out their activities, Caisse portfolio management teams adhere to an investment philosophy based on **five broad principles**.

1 INVEST WITH A LONG-TERM VISION

- Take advantage of the Caisse's size and ability as a long-term investor in order to make the most of investment cycles and market inefficiencies, and gain access to the best investment opportunities.

2 MANAGE FUNDS ACTIVELY

- Favour internal management when the Caisse masters the business skills and has an in-depth understanding of value-creating levers and underlying risks.
- Favour operational asset management in those areas where the Caisse has the requisite expertise.
- Work with long-term partners whose interests are aligned with those of the Caisse and who contribute to the development of internal competencies.

3 PERFORM FUNDAMENTAL RESEARCH WITHIN THE CAISSE

- Develop a long-term view of major macroeconomic and market trends.
- Acquire a thorough understanding of the assets and their market environment.
- Perform a detailed analysis of the business models and the value of the companies held.

4 MANAGE RISKS IN A BALANCED AND PROACTIVE MANNER

- Ensure adequate diversification by asset class and risk factor.
- Proactively integrate risk management for all stages of the investment cycle.
- Actively manage the overall exposure to risk factors.

5 PROMOTE SOCIALLY RESPONSIBLE INVESTMENT

- Consider non-financial matters and investment risks.
- Encourage sound corporate governance practices.

OVERLAY STRATEGIES

In addition to its 17 specialized portfolios, the Caisse has offered overlay strategies since April 1, 2010, allowing each depositor to customize its currency risk exposure. Effective January 1, 2012, depositors may also adjust their exposure to the duration of investments using interest rate overlay mechanisms. The Caisse enhanced its advisory services accordingly to better assist depositors in establishing their investment policies and choosing effective hedging strategies, and in matching their assets to liabilities.

GEOGRAPHIC DIVERSIFICATION

In addition to investing in Québec and Canada, the Caisse is active in global markets with investments in a variety of asset classes. As at December 31, 2011, the proportion of total assets invested abroad was 40.4%, a 4.3% increase from the end of 2010 (see Table 8). Most of the Caisse's investments abroad were made in industrialized countries, mainly the U.S. The share of emerging markets continued to grow, with the Caisse's strategy of taking advantage of the higher economic growth in these countries.

TABLE 8

GEOGRAPHIC BREAKDOWN OF TOTAL ASSETS[1]

(as at December 31 – as a percentage)

	2011	2010
Canada	**59.6**	63.9
United States	**19.8**	16.6
Eurozone	**6.7**	5.9
United Kingdom	**3.8**	4.0
Japan	**1.8**	1.8
Emerging markets	**5.0**	4.7
Other	**3.3**	3.1
Total	**100.0**	100.0

1. Based on the country of the company or issuer headquarters or, for real estate, on the geographical location of the assets.

CURRENCY HEDGING

Most of the investments made abroad in illiquid specialized portfolios, such as the Infrastructure, Real Estate and Private Equity portfolios, are hedged against currency fluctuations using foreign exchange hedging instruments. Moreover, effective April 1, 2010, the Caisse ceased hedging its liquid specialized portfolios, such as publicly traded securities portfolios. The Caisse subsequently established customized overlay strategies, which allow depositors to increase or reduce the currency exposure of their portfolios.

BENCHMARK INDEXES

For each specialized portfolio, except for the Asset Allocation and ABTN portfolios, a benchmark index serves to compare the results of the managers against the corresponding market. The following changes were made to the portfolio indexes:

- On January 1, 2011, the DEX Long Term Government Bond Index (Adjusted) was modified to increase the weighting of the Long Term Bond portfolio in provincial bonds. This weighting was increased again on January 1, 2012.
- On March 1, 2011, the Morningstar National Bank Québec Index was integrated into the Canadian Equity portfolio benchmark index to better represent the reality of the Québec economy within the portfolio.
- Effective January 1, 2012, the Real Estate Debt specialized portfolio index is the DEX Universe Bond Index. The sale of the international component of the portfolio was completed in 2011, warranting the withdrawal of the Giliberto-Levy portion (10%) of the benchmark index.

Table 9 (p. 26) presents the list of specialized portfolio benchmark indexes and their changes over four years.

Overall Portfolio

TABLE 6

CHANGES IN BENCHMARK INDEXES OVER 4 YEARS

(as at December 31, 2011)

SPECIALIZED PORTFOLIO	BENCHMARK INDEX
SHORT TERM INVESTMENTS (Created July 1, 1998)	DEX 91 Day T-Bill
BONDS (Created October 1, 1996)	DEX Universe Bond (Adjusted) since July 1, 2010. Formerly DEX Universe Bond
LONG TERM BONDS (Created April 1, 2005)	DEX Long Term Government Bond (Adjusted) since January 1, 2011, formerly adjusted July 1, 2010. Formerly DEX Long Term Government Bond
REAL ESTATE DEBT (Created April 1, 1995)	Real Estate Debt (index consists of 90% DEX Universe Bond and 10% Giliberto-Levy Hedged) since January 1, 2010. Formerly 90% DEX Universe Bond and 10% Barclays CMBS B Hedged
REAL RETURN BONDS (Created January 1, 2004)	DEX Real Return Bond
INFRASTRUCTURE (Created July 1, 2010)	Infrastructures (index consists of a basket of infrastructure-related public securities, hedged)
REAL ESTATE (Created October 1, 1985)	Aon Hewitt – Real Estate (Adjusted) since January 1, 2010. Formerly Aon-Real Estate
CANADIAN EQUITY (Created July 1, 1995)	Canadian Equity (index consists of 90% S&P/TSX Capped and 10% Morningstar National Bank Québec Index) since March 1, 2011. Formerly S&P/TSX Capped
GLOBAL EQUITY (Created April 1, 2010)	MSCI ACWI Unhedged
QUÉBEC INTERNATIONAL (Created July 1, 1999)	Québec International (index consists of 80% DEX Québec Bond and 20% DEX 91 Day T-Bill, plus a basket of equity futures)
U.S. EQUITY (Created April 1, 2010)	S&P 500 Unhedged
EAFE EQUITY (Created April 1, 2010)	MSCI EAFE Unhedged
EMERGING MARKETS EQUITY (Created January 1, 1995)	MSCI EM Unhedged
PRIVATE EQUITY (Created July 1, 2003)	Private Equity (index consists of 70% State Street Private Equity Index Adjusted and 30% MSCI World, Hedged) effective since July 1, 2010. Formerly 60% S&P 500 Hedged and 40% MSCI EAFE.
HEDGE FUND (Created April 1, 2003)	Dow Jones Credit Suisse Hedge Fund Index Adjusted (Hedged)

BENCHMARK PORTFOLIO

The weighted average of the asset allocation established by the depositors' investment policies makes it possible to determine the composition of the Caisse's benchmark portfolio. As at December 31, 2011, the overall portfolio's asset allocation conformed to the parameters of the benchmark portfolio (see Table 10). During the year, the Caisse reduced its exposure to equities and increased its positions in inflation-sensitive investments.

Currency exposure

During the year, overlay strategies allowed the depositors to vary their currency exposure according to their portfolios and risk tolerance. As at December 31, 2011, the benchmark portfolio included 8.7% U.S. dollar exposure and 9.3% exposure to the basket of EAFE currencies.

TABLE 10

COMPOSITION OF THE BENCHMARK PORTFOLIO AND CHANGES IN THE OVERALL PORTFOLIO

(percentage of depositors' net assets)

	Benchmark portfolio as at December 31, 2011[1]			Overall portfolio	
	Lower limit %	Benchmark portfolio %	Upper limit %	as at December 31, 2011 %	as at December 31, 2010 %
Fixed Income					
Short Term Investments	0.2	1.2	8.6	4.3	2.5
Bonds	21.4	26.4	33.2	26.2	26.4
Long Term Bonds	2.0	2.3	4.3	2.3	2.4
Real Estate Debt	2.9	5.9	8.5	4.2	5.6
Total		35.8		37.0	36.9
Inflation-Sensitive Investments					
Real Return Bonds	0.2	0.8	2.6	0.8	0.6
Infrastructure	1.2	3.9	7.0	3.6	2.9
Real Estate	7.0	10.7	14.0	11.5	11.0
Total		15.4		15.9	14.5
Equity					
Canadian Equity	8.5	12.9	17.5	11.7	12.7
Global Equity	1.9	5.8	9.4	6.8	3.9
Québec International	0.0	3.2	6.3	2.9	5.6
U.S. Equity	1.0	4.9	9.1	5.1	3.8
EAFE Equity	1.6	6.1	10.6	5.7	6.4
Emerging Markets Equity	1.0	3.9	6.4	3.7	3.8
Private Equity	6.5	9.8	13.0	9.9	11.5
Total		46.6		45.8	47.7
Other Investments					
Hedge Funds	0.1	2.2	3.6	2.1	2.2
Asset Allocation	0.0	0.0	1.0	0.8	0.4
ABTN	N/A	N/A	N/A	(1.6)	(1.7)
Total		100.0		100.0	100.0

1. The benchmark portfolio and its upper and lower limits are the result of the weighted average of the depositors' benchmark portfolios.

Analysis of Overall Performance

In a year marked by the European economic crisis and global uncertainty, market volatility increased dramatically, especially in the second half of the year. In this context, the Caisse's management teams combined offensive and defensive strategies to generate significant growth while protecting depositors' capital. As a result of their efforts and the risk management tools developed over the past two years, hedging positions were managed in a flexible manner as risks evolved. The volatility of the returns on the Caisse's overall portfolio was therefore reduced significantly.

HIGHLIGHTS

01 As at December 31, 2011, depositors' funds generated a weighted average return of 4.0%, with net investment results of $5.7 billion.

02 Of the 17 specialized portfolios, 13 posted positive results.

03 Three illiquid portfolios made a major contribution to absolute return, generating returns of 23.3% (Infrastructure), 11.0% (Real Estate) and 7.1% (Private Equity).

04 Annual returns for the seven main depositors varied between 2.8% and 8.1%.

As at December 31, 2011, the Caisse's overall portfolio had a weighted average return on depositors' funds of 4.0%, which is slightly less than the benchmark portfolio, which posted a return of 4.2%.

Thirteen of the 17 specialized portfolios had positive results in 2011 (see Table 12, p. 29). In particular:

- With a return of 10.4%, the four portfolios in the Fixed Income asset class generated net investment results of $5.7 billion.
- The 13.9% return for the three portfolios in the Inflation-Sensitive Investments asset class generated net investment results of $3.1 billion.
- The Private Equity portfolio generated net investment results of $1.1 billion, with a return of 7.1%. This return, which far exceeds the -7.2% return generated by publicly traded equity portfolios, made it possible to limit the decline in value for the Equity asset class to $3.3 billion.

CURRENCY EXPOSURE

As at December 31, 2011, the proportion of total assets invested outside Canada and exposed to currency fluctuations stood at 40.4%. A significant portion of the risk associated with this exposure, however, was hedged by currency derivatives. Considering these derivative instruments, the net exposure was less than 25%.

For 2011, the net foreign currency exposure made a positive contribution to the return on the Caisse's overall portfolio.

FOUR-YEAR RETURN

For the four years ended December 31, 2011, the Caisse generated an annualized return of -0.6%. This result is heavily influenced by the 2008 results, as is shown in Table 11. Since 2009, the Caisse has recorded positive annual returns of between 4.0% and 13.6%, for an annualized return over three years of 9.1%.

The -0.6% result for the four-year period is 215 b.p. (2.15%) below the benchmark index. The difference from the benchmark is mainly attributable to ABTN results and the Real Estate and Real Estate Debt portfolios, as well as asset allocation activities. During the period, the Short Term Investments, Bond, Infrastructure, Private Equity and Hedge Fund portfolios made a particularly positive contribution from a value-added standpoint.

DEPOSITORS' INDIVIDUAL RETURNS

The overall return is based on the weighted average return on depositors' funds. Accordingly, depositors obtain returns based on their investment policy, which determines the proportion of funds invested in each specialized portfolio. In 2011, the returns obtained by the seven main depositors varied from 2.8% to 8.1%. For the four years ended December 31, 2011, the annualized returns of these same depositors ranged from -1.3% to 2.0%.

RETURNS BY SPECIALIZED PORTFOLIO

Table 14 (p. 31) shows the returns of the specialized portfolios relative to their benchmark index for the one-year and four-year periods ending December 31, 2011.

TABLE 11

CAISSE RETURNS

(for periods ended December 31 – as a percentage)

	The Caisse's overall return[1]
2011	**4.0**
2010	13.6
2009	10.0
3 years (2009-2011)	9.1
2008	(25.0)
4 years (2008-2011)	(0.6)

1. Weighted average return on depositors' funds.

TABLE 12

NET ASSETS AND RETURNS IN RELATION TO BENCHMARK INDEXES

(for periods ended December 31, 2011)

		1 year			4 years		
	Net assets	**Return**	**Net investment results**	**Spread**	Return	Net investment results	Spread
Categories	**$B**	**%**	**$M**	**(b.p.)**	%	$M	(b.p.)
Fixed Income	**58.8**	**10.4**	**5,670**	**92**	5.6	12,186	(87)
Inflation-Sensitive Investments	**25.2**	**13.9**	**3,081**	**(140)**	(1.7)	(1,724)	(286)
Equity	**72.8**	**(4.2)**	**(3,299)**	**(80)**	(3.0)	(8,268)	52
Hedge Funds	**3.3**	**0.5**	**4**	**94**	(1.1)	(453)	52
Asset Allocation	**1.2**	**N/A**	**121**	**N/A**	N/A	(1,673)	N/A
ABTN[1]	**(2.5)**	**N/A**	**93**	**N/A**	N/A	N/A	N/A
Total[2]	**159.0**	**4.0**	**5,746**	**(26)**	(0.6)	(4,587)	(215)

1. The ABTN portfolio financing exceeds the fair market value of its investments and mainly accounts for the negative net assets.
2. The total includes Overlay Strategies and cash activities.

Analysis of Overall Performance

OVERALL PORTFOLIO MANAGEMENT

During the first six months of 2011 and considering the market environment, the asset allocation for the overall portfolio remained close to that of the benchmark portfolio. Equity market exposure remained at about 37%.

During the summer, because of the deteriorating economic outlook in the U.S., the downgrade of the U.S. debt rating by Standard & Poor's and the inability of European authorities to put in place a credible solution for the crisis in Greece, the Caisse took defensive action to protect the overall portfolio. In September, there was a risk that the crisis in Greece would spread to the rest of Europe, affecting both the banking sector and the credit quality of the peripheral countries. Due to the threat of a systemic crisis, the Caisse further reduced its equity market exposure, which stood at 30% at the end of September.

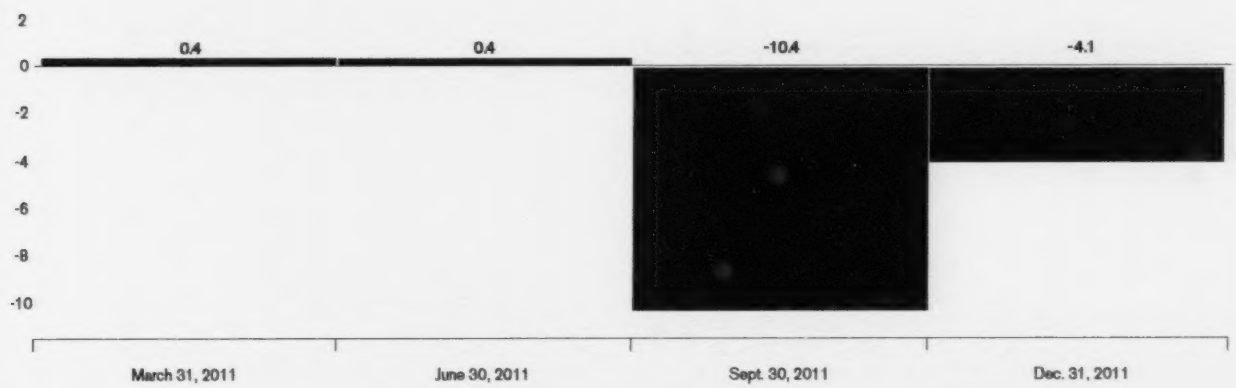
The European Summit held in October made it possible to officially confirm the need to recapitalize European banks and to recognize substantial losses on Greek debt. The systemic risk then gradually diminished with changes in government in both Greece and Italy, as well as the involvement of the European Central Bank in December. In this context, hedging positions were significantly reduced without being totally removed (see Figure 13).

These hedging positions on equity markets were supported, throughout the year, by prudent cash management. Cash therefore varied between $5 billion and $9 billion during the second half of the year.

FIGURE 13

EQUITY MARKETS – DIFFERENCE IN WEIGHTING WITH THE BENCHMARK PORTFOLIO

(in billions of dollars)



1st HALF

- Arab spring
- Tsunami in Japan
- Concerns about European sovereign debt
- Robust corporate profits

3rd QUARTER

- **United States**: Lack of agreement on a credible plan to reduce the country's debt in the medium term and a downgrade by rating agency Standard & Poor's from AAA to AA+, poorer economic outlook, downward revisions of past growth and Federal Reserve's commitment to maintain its key interest rate at a very low level until mid-2013
- **Europe**: Concerns exacerbated by political intransigence and fears of systemic risk

4th QUARTER

- **Europe**: Governments replaced in Greece and Italy and introduction of austerity budget measures and structural reforms in these countries, marked easing of monetary policy by the ECB, including two consecutive cuts of 25 b.p. to its key interest rate and extraordinary support for bank and interbank lending that allowed financial institutions to obtain unlimited funding
- **United States**: Improved economic outlook
- Lower probability of systemic risk, but basic problems remain

TABLE 14

SPECIALIZED PORTFOLIO RETURNS IN RELATION TO BENCHMARK INDEXES

(for periods ended December 31, 2011 – as a percentage unless otherwise indicated)

Specialized portfolio	2011 Index[1]	1 year			4 years		
		Return	**Index**	**Spread**	Return	Index	Spread
		%	**%**	**(b.p.)**	%	%	(b.p.)
Fixed Income							
Short Term Investments[2]	DEX 91 Day T-Bill	**1.1**	**1.0**	**6**	1.6	1.4	25
Bonds	DEX Universe Bond (Adjusted)	**10.1**	**9.8**	**29**	7.4	7.1	31
Long Term Bonds[3]	DEX Long Term Government Bond (Adjusted)	**18.6**	**18.6**	**(8)**	9.2	9.4	(19)
Real Estate Debt	Real Estate Debt	**15.0**	**9.5**	**545**	(0.2)	5.4	(565)
Total		**10.4**	**9.5**	**92**	5.6	6.5	(87)
Inflation-Sensitive Investments							
Real Return Bonds[3]	DEX Real Return Bond	**18.4**	**18.3**	**2**	10.8	10.9	(9)
Infrastructure[4]	Infrastructure	**23.3**	**12.7**	**1,059**	3.4	0.7	266
Real Estate	Aon Hewitt – Real Estate (Adjusted)	**11.0**	**15.6**	**(466)**	(3.7)	1.4	(510)
Total		**13.9**	**15.3**	**(140)**	(1.7)	1.1	(286)
Equity							
Canadian Equity	Canadian Equity	**(10.6)**	**(8.2)**	**(243)**	(1.1)	(0.6)	(54)
Global Equity	MSCI ACWI (Unhedged)	**(5.7)**	**(5.1)**	**(62)**	N/A	N/A	N/A
Québec International	Québec International	**1.6**	**1.9**	**(29)**	(3.6)	(3.1)	(49)
U.S. Equity[2,5]	S&P 500 (Unhedged)	**4.6**	**4.6**	**(2)**	(2.6)	(1.3)	(134)
EAFE Equity[2,6]	MSCI EAFE (Unhedged)	**(9.6)**	**(10.0)**	**34**	(8.2)	(7.9)	(31)
Emerging Markets Equity[2]	MSCI EM (Unhedged)	**(16.4)**	**(16.4)**	**0**	(6.1)	(4.5)	(165)
Equity Markets		**(7.2)**	**(6.3)**	**(90)**	(3.5)	(3.0)	(58)
Private Equity	Private Equity	**7.1**	**7.4**	**(30)**	0.8	(5.0)	582
Total		**(4.2)**	**(3.4)**	**(80)**	(3.0)	(3.5)	52
Other Investments							
Hedge Funds	Dow Jones Credit Suisse Hedge Fund Index (Adjusted Hedged)	**0.5**	**(0.5)**	**94**	(1.1)	(1.6)	52
Asset Allocation[7]		**$121 M**	**N/A**	**N/A**	$(1,673) M	N/A	N/A
ABTN[7]		**$93 M**	**N/A**	**N/A**	N/A	N/A	N/A
Weighted average return on depositors' funds		**4.0**	**4.2**	**(26)**	(0.6)	1.5	(215)

1. The description of the indexes is presented in Table 9, p. 26.
2. These portfolios have been indexed since April 1, 2010.
3. These portfolios have been indexed since January 1, 2010.
4. This line includes the Investments and Infrastructures portfolio from January 1, 2008 to June 30, 2010, and the Infrastructure portfolio since July 1, 2010.
5. This line includes the U.S. Equity (Hedged) and U.S. Equity (Unhedged) portfolios from January 1, 2008 to March 31, 2010, and the U.S. Equity portfolio since April 1, 2010.
6. This line includes the Foreign Equity (Hedged) and Foreign Equity (Unhedged) portfolios from January 1, 2008 to March 31, 2010, and the Europe, Australasia & Far East (EAFE) Equity portfolio since April 1, 2010.
7. The returns in dollars are cumulative and net of operating expenses and other fees.

Analysis of Performance by Asset Class

FIXED INCOME

As at December 31, 2011, Fixed Income consisted of four portfolios. The Bond and Real Estate Debt portfolios, with total net assets of $48.3 billion, are actively managed. The Short Term Investment and Long Term Bond portfolios, with total net assets of $10.5 billion, are indexed.

HIGHLIGHTS

01 The overall return for the Fixed Income class was 10.4%, 92 b.p. (0.92%) above the benchmark index.

02 The Bond portfolio, which is actively managed, achieved a return of 10.1%, outperforming the benchmark index by 29 b.p. (0.29%).

03 The refocusing of Real Estate Debt activities was completed in 2011. The Real Estate Debt portfolio, which is actively managed, generated a return of 15.0%, outperforming its benchmark by 545 b.p. (5.45%).

04 A $408 million stake in the bonds issued by Health Montréal Collective Limited Partnership, which is building and managing the new Centre hospitalier de l'Université de Montréal (CHUM), is one of the Bond portfolio's new investments in Québec.

MARKET ENVIRONMENT

Bond Markets

The Canadian bond market had another year of good returns in 2011, for both government and corporate bonds. This is largely explained by the sharp decline in federal bond rates in Canada in 2011, essentially during the second half of the year (see Figure 15, p. 33). This decline is mainly attributable to the precarious political and economic situation in the rest of the world, coupled with a more favourable fiscal situation in Canada, which contributed to the Canadian government's AAA credit rating being maintained.

The global bond markets also had a positive year. The solvency of countries on Europe's southern periphery (Greece, Portugal, Spain and Italy) was a focus of concern from August onward. Although stabilization measures (debt buybacks on the secondary markets and bank recapitalizations) were implemented, a bleaker economic outlook and increased risk aversion in the second half of the year drove down long-term yields in major markets. Yields on 10-year government bonds in Canada, the U.S. and Germany ended the year at historical lows of less than 2%.

Real Estate Debt

The Canadian commercial real estate debt market also benefited from this situation and had a very positive year in 2011. With relatively stable mortgage rate spreads, the sharp decline in Canadian interest rates made it possible to achieve strong returns for the year. In addition, improvements in certain fundamental factors relevant to real estate, such as occupancy rates, enhanced the value of the assets underlying the loans. Moreover, the rate of defaults and level of losses on Canadian commercial mortgage loans remained very low.

PORTFOLIO RETURNS

For 2011, the overall return for Fixed Income was 10.4%, 92 b.p. (0.92%) above the benchmark index (see Table 16, p. 34).

Short Term Investments

Description

The Short Term Investment portfolio is invested in securities of the best quality and the highest liquidity. Its features are very close to those of its benchmark index, the DEX 91 Day T-Bill, composed of treasury bills issued by the Government of Canada. Considered to be risk-free, this portfolio generates a fairly low return but it does provide capital protection, considerable liquidity and diversification.

Returns

The Short Term Investment portfolio generated a return of 1.1%, which is 6 b.p. (0.06%) above the benchmark index (see Table 16, p. 34). This reflects the very low short-term rates. The targeted rate for one-day financing has been unchanged, at 1%, since September 2010.

Bonds

Description

The Bond portfolio consists mainly of bonds issued by the Government of Canada, the governments of the provinces of Canada and various public and private corporations. The portfolio provides a return commensurate with its low level of risk and is a source of current income and liquidity. It also provides diversification and helps protect the overall portfolio.

Strategy

The portfolio is actively managed, focusing on diversifying the sources of value added. The strategies implemented evolve with the economic and monetary cycles, and relative-value activities contribute regularly to returns.

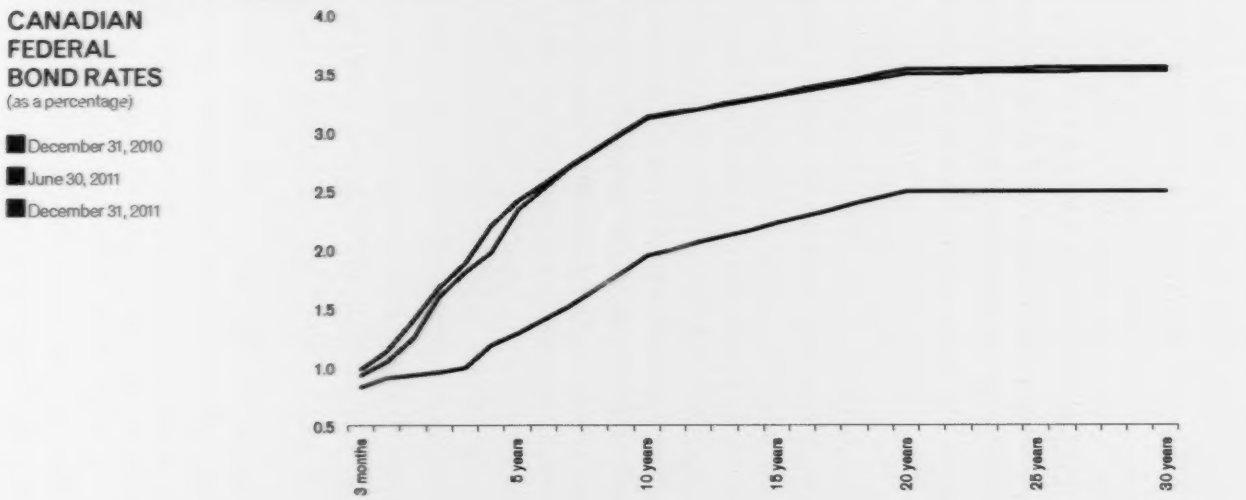
Returns

The Bond portfolio generated a return of 10.1%, or 29 b.p. (0.29%) above the benchmark index (see Table 16, p. 34). The decrease in medium- and long-term interest rates during the year had a positive impact on portfolio returns. Two-thirds of the total return stems from increases in value resulting from this decline. The value added provided by the portfolio comes from activities relating to corporate bonds. Active interest rate strategies subtracted value slightly.

A $408 million stake in the bonds issued by the Health Montréal Collective Limited Partnership, the builder and manager of the new Centre hospitalier de l'Université de Montréal (CHUM), is one of the Bond portfolio's new investments in Québec. This type of investment offers terms and yields that are especially well suited to the portfolio's long-term investment horizon. The managers also took advantage of the market opportunity to invest in Québec municipal bonds.

FIGURE 13

CANADIAN FEDERAL BOND RATES
(as a percentage)



Analysis of Performance by Asset Class

Table 17 (p. 35) presents the DEX Bond Index returns according to maturity and issuer. As was the case in 2010, returns were heavily influenced by the drop in medium- and long-term interest rates. However, this decrease was more pronounced in 2011 and also affected the short-term segment of the curve, which explains the higher returns for all sub-indexes. The increase in rate spreads negatively affected returns on corporate bonds, however.

Long Term Bonds

Description

The Long Term Bond portfolio is indexed, that is, it seeks to achieve a return equivalent to the index that it replicates. The DEX Long Term Government Bond Index (Adjusted) is composed of 25% DEX Federal Long Term Bond Index, 25% DEX Long Term Provincial Bond Index and 50% DEX Long Term Québec Bond Index. The portfolio provides returns consistent with the low level of risk and generates current income.

Returns

The Long Term Bond portfolio posted a return of 18.6%, almost the same as the benchmark index (see Table 16). Close to 80% of the return is attributed to the decrease in long-term rates on government bonds in the portfolio. These rates declined from 4% to 3% and had a particularly positive impact on the returns for this portfolio, given its long duration.

Real Estate Debt

Description

The Real Estate Debt portfolio essentially includes Canadian commercial mortgages. It also includes bridge loans, lower-ranking mortgages and mortgage-backed securities (MBS). The portfolio is expected to generate a higher return than bonds and also generates high and relatively stable current income. The credit risk is low due to a prudent underwriting approach and the quality of the underlying assets.

Strategy

The portfolio is actively managed. The managers are able to carry out various securitization and syndication operations as well as acquire or sell mortgage assets to re-balance and diversify the portfolio or mitigate the risk of individual transactions. Since 2010, the portfolio's credit risk was significantly reduced by refocusing the portfolio strategy towards higher-quality Canadian assets.

Returns

The Real Estate Debt portfolio generated a return of 15.0%, or 545 b.p. (5.45%) above the benchmark index (see Table 16). This return is explained by the drop in Canadian mortgage rates, the current yields and the gain related to the orderly sale of international assets.

TABLE 16

SPECIALIZED PORTFOLIO RETURNS – FIXED INCOME

(for periods ended December 31, 2011)

		1 year			4 years		
	Depositors' net assets $B	Return %	Index[1] %	Spread[2] (b.p.)	Return %	Index[1] %	Spread[2] (b.p.)
Short Term Investments[3]	**6.8**	**1.1**	**1.0**	**6**	1.6	1.4	25
Bonds	**41.6**	**10.1**	**9.8**	**29**	7.4	7.1	31
Long Term Bonds[4]	**3.8**	**18.6**	**18.6**	**(8)**	9.2	9.4	(19)
Real Estate Debt	**6.7**	**15.0**	**9.5**	**545**	(0.2)	5.4	(565)
Total	**58.8**	**10.4**	**9.5**	**92**	5.6	6.5	(87)

1. The description of the indexes is presented in Table 9, p. 26.
2. Compared to the benchmark indexes.
3. This portfolio has been indexed since April 1, 2010.
4. This portfolio has been indexed since January 1, 2010.

TABLE 17

DEX BOND INDEX RETURNS

(as a percentage)

DEX Bond Indexes	2011 Short Term	2011 Medium Term	2011 Long Term	2011 Total	2010 Short Term	2010 Medium Term	2010 Long Term	2010 Total
Federal	**4.5**	**11.6**	**19.8**	**8.4**	3.2	7.2	12.2	5.4
Provincial	**5.1**	**11.5**	**18.2**	**13.2**	3.8	7.8	11.8	8.6
Québec	**5.4**	**11.3**	**18.2**	**13.6**	3.7	7.9	11.8	8.9
Corporate	**4.7**	**9.0**	**15.8**	**8.2**	4.3	8.2	14.2	7.3
Universe	**4.7**	**10.9**	**18.1**	**9.7**	3.6	7.8	12.5	6.7

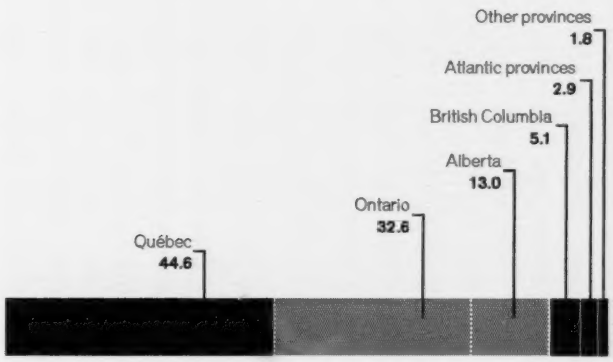
As at December 31, 2011, the Real Estate Debt portfolio was invested exclusively in Canadian assets, with 44.6% of its investments in Québec (see Figure 18).

As at December 31, 2011, investments in the office building sector represented the largest portion of the portfolio (see Figure 19).

FIGURE 18

GEOGRAPHIC BREAKDOWN – REAL ESTATE DEBT

(as a percentage of fair value as at December 31, 2011)[1]

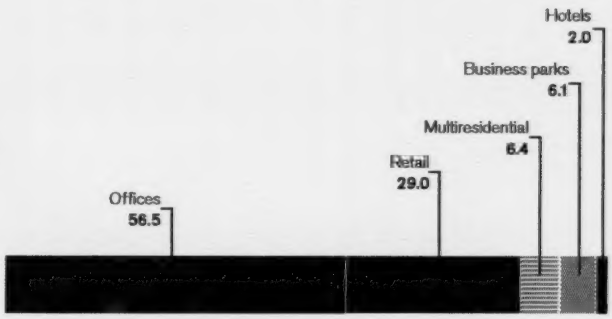


1. Percentages do not include the cash in the portfolio.

FIGURE 19

SECTOR BREAKDOWN – REAL ESTATE DEBT

(as a percentage of fair value as at December 31, 2011)[1]



1. Percentages do not include the cash in the portfolio.

Analysis of Performance
by Asset Class

INFLATION-SENSITIVE INVESTMENTS

As at December 31, 2011, Inflation-Sensitive Investments consisted of three portfolios. The Infrastructure and Real Estate portfolios, with total net assets of $24.0 billion, are actively managed. The Real Return Bond portfolio, with total net assets of $1.3 billion, is indexed.

HIGHLIGHTS

01 The overall performance of Inflation-Sensitive Investments was 13.9%, 140 b.p. (1.40%) below the benchmark index.

02 The Real Return Bond portfolio generated a return of 18.4%, in line with the benchmark index.

03 The return on the Infrastructure portfolio was 23.3%, which is 1,059 b.p. (10.59%) above the benchmark index. The portfolio's net assets increased from $4.3 billion to $5.8 billion.

04 The Real Estate portfolio generated a return of 11.0%, which is 466 b.p. (4.66%) below the benchmark index. The portfolio was repositioned in order to increase investments in the multiresidential property sector and decrease exposure to the hotel sector.

MARKET ENVIRONMENT

From December 2010 to December 2011, the inflation rate in Canada stood at 2.3% whereas the Bank of Canada's median inflation target is 2%. Inflation expectations therefore remained relatively stable during the year.

Real Return Bonds

Lower medium- and long-term rates benefited real return bonds in this market environment.

Infrastructure and Real Estate

Low interest rates and particularly volatile equity markets triggered a significant increase in the market's appetite for less liquid assets, such as infrastructure and real estate, as a result of the stable and high current income they offer and their lower risk profile relative to equities. In spite of the volatile credit market and the economic slowdown, projects and assets with excellent fundamentals continued to be able to attract financing at low rates, and allowed them to post high returns.

The resumption of activity in the infrastructure sector that began in 2010 continued in 2011, with a marked increase in investment in this asset class. Globally, there was a total of 144 infrastructure funds in the fourth quarter, with a targeted amount of $93 billion.[1]

This phenomenon was also seen in real estate. The solid performance recorded in Canada in 2010 continued for commercial real estate assets. In the United States and Europe, investments in certain market segments of commercial real estate, completely offset the losses incurred during the 2008 financial crisis. In Europe, sales of real estate assets by banks and governments resulted in increased offerings on the market. Prices therefore stabilized somewhat toward year end.

1. Source: Preqin

PORTFOLIO RETURNS

The overall return on Inflation-Sensitive Investments was 13.9% in 2011, which is 140 b.p. (1.40%) below the benchmark index (see Table 20).

Real Return Bonds

Description

The Real Return Bond portfolio is indexed, that is, it seeks to achieve a return equivalent to the index that it replicates. The DEX Real Return Bond Index is composed of bonds issued by the governments of Canada, Québec, Ontario and Manitoba. The portfolio provides returns in proportion to its low level of risk and protects against inflation.

Returns

The Real Return Bond portfolio generated a return of 18.4%, in line with the benchmark (see Table 20). Of this return, 2.9% is due to inflation. Most of the returns are attributable to real interest rates during the year, which decreased from 1.1% in 2010 to 0.3% in 2011, a decline of 0.8%. The rate decrease had a particularly positive effect on returns for this portfolio given its long duration.

Infrastructure

Description

The Infrastructure portfolio includes investments offering a high current yield, with stable and predictable long-term revenues, while aiming to hedge against long-term inflation. It mainly includes direct stakes in companies that operate airports, oil, gas and electricity transmission and distribution systems, water distribution systems and passenger transportation contracts and concessions.

Strategy

The portfolio's strategy involves making direct, long-term investments with strategic and financial partners. Active management targets high-quality companies that stand out due to their lower risk profile and reduced sensitivity to economic fluctuations. The portfolio is composed of regulated, monopolistic assets and assets with revenues under long-term contracts, generating stable and high cash flows that are predictable in the long term.

Returns

The Infrastructure portfolio generated a return of 23.3%, which is 1,059 b.p. (10.59%) above the benchmark index (see Table 20). This return, which exceeds that expected in the long term, stems from the positive operational performance of the companies held and the decrease in long-term interest rates. In particular, the performance of assets in the energy and airport services sectors, including Trencap (Noverco) and BAA, largely explain this level of performance. The value of the assets in the portfolio at year end was confirmed by certain transactions carried out by managers and industry players during the year.

TABLE 21

SPECIALIZED PORTFOLIO RETURNS – INFLATION-SENSITIVE INVESTMENTS

(for periods ended December 31, 2011)

		1 year			4 years		
	Depositors' net assets $B	**Return %**	**Index[1] %**	**Spread[2] (b.p.)**	Return %	Index[1] %	Spread[2] (b.p.)
Real Return Bonds[3]	**1.3**	**18.4**	**18.3**	**2**	10.8	10.9	(9)
Infrastructure[4]	**5.8**	**23.3**	**12.7**	**1,059**	3.4	0.7	266
Real Estate	**18.2**	**11.0**	**15.6**	**(466)**	(3.7)	1.4	(510)
Inflation-Sensitive Investments	**25.2**	**13.9**	**15.3**	**(140)**	(1.7)	1.1	(286)

1. The description of the indexes is presented in Table 9, p. 26.
2. Compared to the benchmark indexes.
3. This portfolio has been indexed since January 1, 2010.
4. This line combines the Investments and Infrastructures portfolio from January 1, 2008 to June 30, 2010, and the Infrastructure portfolio since July 1, 2010.

Analysis of Performance by Asset Class

New investments totaling $1.6 billion were made in the portfolio in 2011. They include two major investments: €360 million in Fluxys, an infrastructure transportation company operating in Belgium that supplies and ensures the sound operation of the natural gas market in Northwestern Europe, and US$850 million in Colonial Pipeline, the largest refined-petroleum-product pipeline in the U.S. Managers also carried out transactions with third parties regarding certain assets and took advantage of extremely low interest rates to complete certain refinancings.

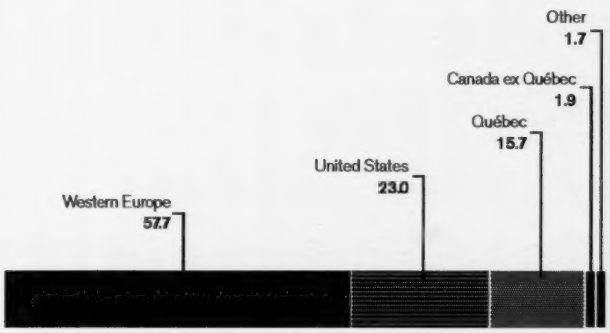
Investments in Western Europe accounted for the largest portion of the Infrastructure portfolio as at December 31, 2011 (see Figure 21). The managers have in-depth knowledge of this market, where the Caisse has had private infrastructure holdings for many years, and rely on the support of excellent partners to make investments.

From a sector standpoint, Figure 22 shows that investments in the Energy and Industry sectors accounted for most of the portfolio at the end of 2011. The portfolio's assets in the Energy sector relate to energy infrastructure (oil, natural gas and electricity transportation and distribution systems) and have no direct exposure to underlying commodity prices.

FIGURE 21

GEOGRAPHIC BREAKDOWN – INFRASTRUCTURE

(as a percentage of fair value as at December 31, 2011)[1]

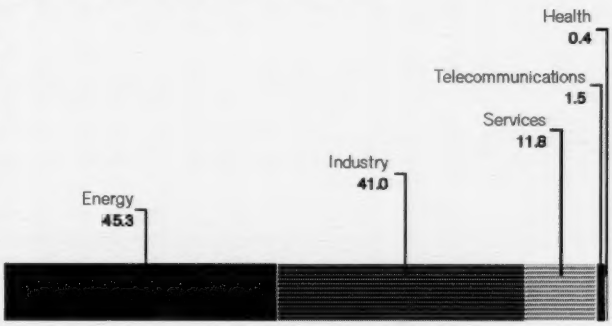


1. Percentages do not include the cash in the portfolio.

FIGURE 22

SECTOR BREAKDOWN – INFRASTRUCTURE

(as a percentage of fair value as at December 31, 2011)[1]



1. Percentages do not include the cash in the portfolio.

Real Estate

Description

The Real Estate portfolio is mainly composed of direct investments in retail, office and multiresidential properties. Investments are also made in private real estate investment funds and hotels.

The portfolio is expected to generate a high return and its current yield is higher than that of fixed-income securities. With little correlation or negative correlation with other specialized portfolios, the Real Estate portfolio provides diversification and hedges against high inflation.

Strategy

The Real Estate portfolio is actively managed using a diversification approach and focuses on investments in high-quality real estate situated mainly in the best markets. The overall strategy consists of making prudent and profitable long-term investments in real estate.

In 2011, portfolio managers implemented a strategy to reposition the portfolio based on a risk-return profile that better takes depositors' needs and market fundamentals into account. This strategy led to increased investments in the multiresidential property sector and decreased exposure to the hotel sector.

Returns

As at December 31, 2011, the Real Estate portfolio generated a return of 11.0%, 466 b.p. (4.66%) below the benchmark index (see Table 20, p. 37). This return is mainly attributable to increased values of retail and office buildings in Canada and the U.S. The high cash levels in the portfolio, close to $4 billion at the end of 2011, account for approximately half of the difference between the portfolio's return and its index. The other half stems from weak returns on non-strategic assets, such as hotels, funds and other equities held in the portfolio, compared to retail space, office buildings and multiresidential property sector, which the Caisse intends to emphasize in the future.

In 2011, portfolio acquisitions amounted to $1.6 billion. Closed transactions include the acquisition of several multiresidential properties, including the Rockhill complex in Montréal and The Park Kiely in San Jose, California, as well as increased investments in several projects in Brazil and the signing of an agreement to purchase the Petra office tower (under construction) in Boulogne-Billancourt, Paris. Moreover, several development projects have been approved, such as those for Eighth Avenue Place (Phase II) in Calgary and Metrotown III in Vancouver. There were also sales of hotels and multiresidential buildings in Canada and the U.S., as well as office buildings in New York and Boston. These sales, totaling $3.8 billion, generated liquidity that will be used to fund future investments.

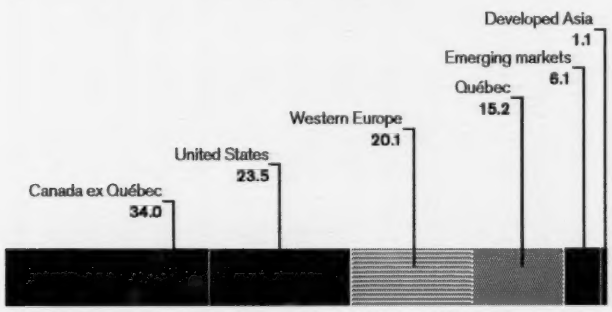
As at December 31, 2011, investments in Canada accounted for 49.2% of the fair value of the portfolio while investments in the U.S. represented 23.5% of this value compared to 47.3% and 23.8%, respectively, as at December 31, 2010 (see Figure 23).

As at December 31, 2011, retail assets represented the largest portion of the portfolio, followed by office buildings (see Figure 24).

FIGURE 23

GEOGRAPHIC BREAKDOWN – REAL ESTATE

(as a percentage of fair value as at December 31, 2011)[1]

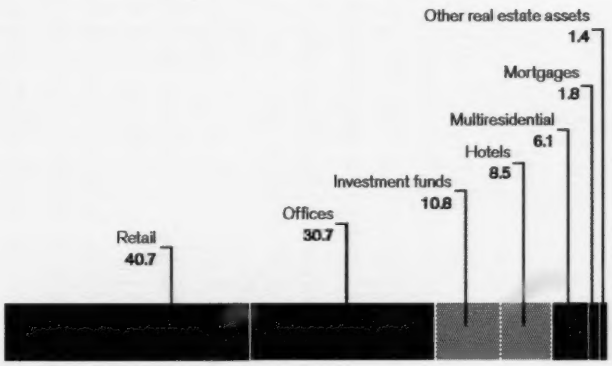


1. Percentages do not include the cash in the portfolio.

FIGURE 24

SECTOR BREAKDOWN – REAL ESTATE

(as a percentage of fair value as at December 31, 2011)[1]



1. Percentages do not include the cash in the portfolio.

Analysis of Performance by Asset Class

EQUITY

The Equity asset class consisted of seven portfolios as at December 31, 2011. The Canadian Equity, Global Equity, Québec International and Private Equity portfolios, with total net assets of $49.7 billion, are actively managed. The U.S. Equity, EAFE Equity and Emerging Markets Equity portfolios, with total net assets of $23.1 billion, are indexed.

HIGHLIGHTS

01 Equity reported an overall return of -4.2%, 80 b.p. (0.80%) below the benchmark index. Net assets totaled $72.8 billion as at December 31, 2011.

02 The Morningstar National Bank Québec Index, comprised exclusively of Québec businesses, was integrated into the Canadian Equity portfolio's benchmark index.

03 The U.S. Equity portfolio, which is indexed and not hedged against currency risk, generated an absolute return of 4.6%, benefiting in particular from the rise of the U.S. dollar.

04 The Private Equity portfolio generated a return of 7.1%, far outperforming equity indexes but slightly below (-30 b.p. or -0.30%) the returns of its benchmark index.

MARKET ENVIRONMENT

Equity Markets

After a rather promising start to the year, most equity markets recorded major losses in the third quarter. These losses were mainly due to uncertainty regarding various factors:

- Sovereign debt problems in Europe.
- Political debate in the U.S. over raising the debt ceiling, followed by the downgrade of the U.S. sovereign credit rating from AAA to AA+ by Standard & Poor's.
- Significant downward revisions of GDP data in the United States.
- A possible economic slowdown in emerging markets.

Over all, despite the average increase in earnings of publicly listed companies, most major equity indexes declined in 2011 (see Figure 26, p. 42):

- The Canadian market declined 8.7% (S&P/TSX);
- Markets in Europe, Australasia, the Far East (EAFE) declined by 10.0% (MSCI EAFE);
- Markets in emerging countries decreased by 16.4% (MSCI EM).

Within EAFE markets, the European markets were especially hard hit, posting declines of close to 16%. Of all major market indexes, only the S&P 500 ended the year in positive territory, with an increase of 4.6%.

European markets mainly felt the ill effects of the sovereign debt crisis, which raised some very serious concerns regarding the health of the banks in the eurozone. Emerging markets and Canada declined as a result of uncertainty surrounding global growth. The U.S. market managed to resist declines due to its more defensive sector mix and reassuring economic news at the end of the year.

Private Equity
The Private Equity market saw two trends in 2011. The first six months were marked by a high level of activity characterized by a large number of refinancings, mergers and acquisitions and initial public offerings.

The situation was completely reversed in the second half of the year. The financing market completely dried up. The mergers and acquisitions and initial public offering markets also slowed significantly. However, market conditions were positive for development capital transactions since companies sought quality partners to achieve and ensure their future growth.

PORTFOLIO RETURNS

The overall return on Equity for 2011 was -4.2%, which is 80 b.p. (0.80%) below the benchmark index (see Table 25).

Canadian Equity
Description
The Canadian Equity portfolio is mainly composed of the securities of public companies. It offers the possibility of a long-term return exceeding that of fixed-income securities while hedging against long-term inflation.

Strategy
The portfolio is actively managed with a long-term horizon. Security selection is based on a qualitative analysis of the fundamental value of businesses, supported by a macro-economic analysis. This approach is rounded out with absolute-performance strategies having a low correlation with the equity market.

TABLE 25

SPECIALIZED PORTFOLIO RETURNS – EQUITY
(for periods ended December 31, 2011)

		1 year			4 years		
	Depositors' net assets $B	Return %	Index[1] %	Spread[2] (b.p.)	Return %	Index[1] %	Spread[2] (b.p.)
Canadian Equity	18.6	(10.6)	(8.2)	(243)	(1.1)	(0.6)	(54)
Global Equity	10.9	(5.7)	(5.1)	(62)	N/A	N/A	N/A
Québec International	4.5	1.6	1.9	(29)	(3.6)	(3.1)	(49)
U.S. Equity[3,4]	8.1	4.6	4.6	(2)	(2.6)	(1.3)	(134)
EAFE Equity[3,5]	9.1	(9.6)	(10.0)	34	(8.2)	(7.9)	(31)
Emerging Markets Equity[3]	5.9	(16.4)	(16.4)	0	(6.1)	(4.5)	(165)
Equity Markets	57.1	(7.2)	(6.3)	(90)	(3.5)	(3.0)	(58)
Private Equity	15.7	7.1	7.4	(30)	0.8	(5.0)	582
Equity	72.8	(4.2)	(3.4)	(80)	(3.0)	(3.5)	52

1. The description of the indexes is presented in Table 9, p. 26.
2. Compared to the benchmark indexes.
3. These portfolios have been indexed since April 1, 2010.
4. This line includes the U.S. Equity (Hedged) and U.S. Equity (Unhedged) portfolios from January 1, 2008 to March 31, 2010, and the U.S. Equity portfolio since April 1, 2010.
5. This line includes the Foreign Equity (Hedged) and Foreign Equity (Unhedged) portfolios from January 1, 2008 to March 31, 2010, and the Europe, Australasia & Far East (EAFE) Equity portfolio since April 1, 2010.

Analysis of Performance by Asset Class

Returns

The Canadian Equity portfolio generated a return of -10.6%, which is 243 b.p. (2.43%) below the benchmark index (see Table 25, p. 41). This return is far below that of the U.S. Equity index and shows that Canadian equity markets are strongly correlated with emerging markets. The difference between the return on the portfolio and its benchmark index is attributable to two factors:

- Some of the portfolio's long-term positions, which relate to urbanization in emerging countries and the strong demand for basic materials, did not perform as well in 2011. These positions have paid off over the long-term, however, and should continue to do so in the future.
- The portfolio's under-exposure to high-dividend-yielding companies, which outperformed in 2011 due to the substantial drop in interest rates.

On March 1, 2011, the new Morningstar National Bank Québec Index, comprised of Québec businesses, was integrated into the benchmark index for the Canadian Equity portfolio to better represent the reality of the Québec economy within the portfolio. The weighting of Québec securities within the portfolio increased by 4% in 2011, to 21%. In comparison, Québec companies account for only 11% of the S&P/TSX Index.

Global Equity

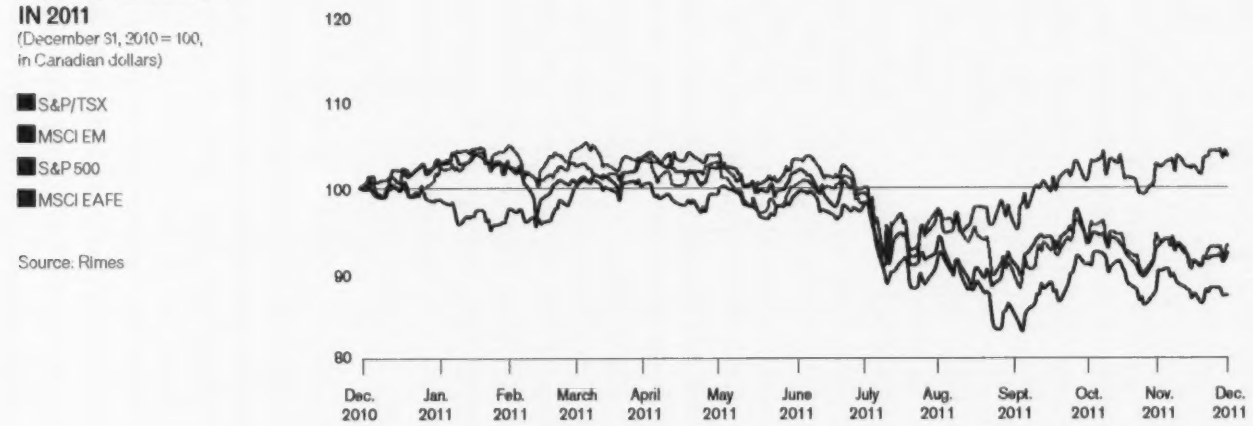
Description

The Global Equity portfolio consists of securities traded in markets in the countries that make up the MSCI ACWI (United States, Canada, Europe, Australasia, Far East and emerging markets). It offers the possibility of a long-term return exceeding that of fixed-income securities while providing geographic diversification and hedging against long-term inflation.

FIGURE 21

DEVELOPMENTS IN EQUITY MARKETS IN 2011

(December 31, 2010 = 100, in Canadian dollars)



Source: Rimes

Strategy
The portfolio is actively managed using four different approaches: internally managed sector-specific portfolios, absolute return strategies with low equity market correlation, externally managed sector- and country-specific mandates and investments on the Shanghai and Shenzhen stock exchanges as a Qualified Foreign Institutional Investor (QFII), a designation that has been granted to the Caisse by the regulatory authorities in China.

In 2011, the managers finished implementing their new external management strategy, involving specialized managers in countries such as China, India and Brazil and specific sectors of the economy.

Returns
The Global Equity portfolio generated a return of -5.7%, 62 b.p. (0.62%) below its benchmark index (see Table 25, p. 41). The difference with the index is mainly attributable to positions in the healthcare, industrial products and natural resources sectors.

Québec International

Description
The Québec International portfolio is composed of futures on world indexes, weighted according to the GDP of the various countries. Futures are capitalized on the basis of 20% 91-day treasury bills and 80% Québec government bonds. The portfolio offers the possibility of a long-term return that exceeds that of stock market indexes while providing current income. Forecast to close, the activities of this portfolio will cease on December 31, 2012.

Returns
The Québec International portfolio generated a return of 1.6%, 29 b.p. (0.29%) below the benchmark index (see Table 25, p. 41). This return exceeds that of the Global Equity portfolio, primarily due to high returns on bonds included in the portfolio. The absence of emerging countries in this portfolio was also a favourable factor in 2011.

U.S. Equity

Description
The U.S. Equity portfolio is indexed, that is, it seeks a return equivalent to the index that it replicates. The S&P 500 Index comprises 500 public companies representing approximately 75% of U.S. equity market capitalization. This portfolio offers the possibility of a long-term return that exceeds the yield on fixed-income securities while hedging against long-term inflation.

Returns
The U.S. Equity portfolio generated a return of 4.6%, practically identical to its benchmark index (see Table 25, p. 41). Unhedged against currency risks, it benefited from the strength of the U.S. dollar against the Canadian dollar.

EAFE Equity

Description
This portfolio is indexed, that is, it seeks a return equivalent to the index that it replicates. The MSCI EAFE Index is composed of the equity market indexes of 22 developed countries: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom. The portfolio offers the possibility of a long-term return that exceeds that of fixed-income securities while providing geographic diversification and hedging against long-term inflation.

Returns
The EAFE Equity portfolio generated a return of -9.6%, 34 b.p. (0.34%) above the benchmark index (see Table 25, p. 41). This difference with the index is mainly attributable to the fact that the realized tax rate on dividends in some countries is lower than the rate used to calculate the MSCI EAFE Index. In 2011, there was a disparity among returns for index components, with declines of 15.6% for countries in the European monetary union and 12.2% for Japan, compared to a decrease of 0.1% in the U.K.

Emerging Markets Equity

Description
This portfolio is indexed, that is, it seeks a return equivalent to the index that it replicates. The MSCI EM Index is composed of the equity market indexes of 21 emerging countries: Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey. The portfolio offers the possibility of long-term returns that exceed the return on equities of developed countries while providing geographic diversification.

Returns
The Emerging Markets Equity portfolio generated a return of -16.4%, identical to the return of its benchmark index (see Table 25, p. 41). The equity markets of emerging countries all recorded major declines in 2011: -15.4% in Asia, -17.4% in Latin America and -19.6% in Eastern Europe.

Analysis of Performance by Asset Class

Private Equity

Description

Almost 45% of the Private Equity portfolio is composed of direct stakes in companies operating in various economic sectors, especially defensive sectors and niches offering stable and predictable cash flows. It also includes stakes in profitable investment funds making it possible to position the Caisse strategically in certain industries and geographic areas. The portfolio offers the possibility of returns in excess of those of equity markets over the long term.

Strategy

The portfolio is actively managed, focusing on industries or types of investments based on economic cycles and market inefficiencies: leveraged buyout financing, development capital, subordinated debt and distressed debt activities carried out with specialized funds. The companies targeted for investment stand out due to their value-creation strategy, competitive advantages, resilient financial results and moderate use of leverage. The managers pay close attention to the quality of the management teams and the partners with whom they associate in order to plan for operational improvements that can improve returns resulting from company growth.

Returns

The Private Equity portfolio generated a return of 7.1%, which largely exceeds the returns on equity markets but is slightly below (-30 b.p. or -0.30%) the return on the benchmark index (see Table 25, p. 41). From a longer-term perspective, which is more representative of this type of investment, the portfolio's return exceeded that of the benchmark index for most periods. Leveraged buyouts and investment funds generated most of the returns.

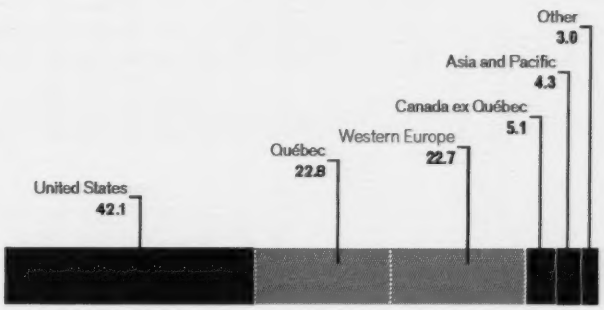
During the first six months of 2011, the managers took advantage of favourable market conditions to reposition the managed funds with transactions on the secondary market, resulting in net cash inflows in excess of $1 billion. The companies held were very active on financial markets, taking advantage of low rates to reduce funding costs and review loan maturities. This, together with the internally generated capital, also reduced the risk profile of holdings, thereby further improving the portfolio quality.

New investments in the portfolio totaled $2.5 billion, including $1.3 billion in direct investments ($650 million in Québec), and $1.2 billion in funds. Direct stakes in SPIE (€160 million), Industrial Alliance ($100 million – see box, p. 73), Kruger ($215 million), GENIVAR ($80 million), and in a Cascades Group project ($80 million) are some of the investments made in 2011.

Figure 27 shows that investments in the U.S. accounted for 42.1% of the fair value of the portfolio as at December 31, 2011, followed by investments in Québec (22.8%) and Western Europe (22.7%).

FIGURE 27

GEOGRAPHIC BREAKDOWN – PRIVATE EQUITY
(as a percentage of fair value as at December 31, 2011)[1]



1. Percentages do not include the cash in the portfolio.

OTHER INVESTMENTS

HIGHLIGHTS

01 The Hedge Fund portfolio generated a return of 0.5%, 94 b.p. (0.94%) above the benchmark index.

02 The Hedge Fund portfolio management team continued to adopt the best practices on governance advocated by the Hedge Fund Standards Board.

03 The Asset Allocation portfolio contributed $121 million to net investment results.

04 The ABTN portfolio contributed $93 million to net investment results.

MARKET ENVIRONMENT

Hedge Funds

The hedge fund industry recorded net cash inflows of US$70.6 billion[1] in 2011, compared to US$55.5 billion in 2010, which reflects investors' interest in this asset class. However, due to economic uncertainty and considerable market volatility, 2011 proved to be a difficult year for several strategies. This was especially true for managers focused on fundamental analysis of companies and sectors.

PORTFOLIO RETURNS

Hedge Funds

Description

The Hedge Fund portfolio is composed of investments in external hedge funds. It provides the possibility of a return that is higher than the return on bonds but lower than the return on equities, with a view to ensuring preservation of capital. It also provides diversification due to its low correlation with traditional asset classes, such as bonds and listed equities.

Strategy

The portfolio is actively managed with emphasis on diversification of strategies, selection of external managers and operational due diligence audits.

In 2011, the portfolio management team took a defensive stand in order to preserve capital, preferring funds that follow macro trends and equity funds with low market exposure. The team also continued to adopt the best practices on governance advocated by the Hedge Fund Standards Board, in particular regarding the transparency of assets included in the portfolio.

Returns

As at December 31, 2011, the Hedge Fund portfolio generated a return of 0.5%, or 94 b.p. (0.94%) above the benchmark index (see Table 29, p. 47). Macro trend strategies had the best performance, in particular by making the most of declines in short- and long-term interest rates. Conversely, event-based strategies and emerging market equity strategies experienced some difficulties due to market volatility combined with high correlation among equities.

1. Source: Hedge Fund Research

Analysis of Performance by Asset Class

Asset Allocation

Description

The Asset Allocation portfolio is composed of various positions on financial markets in the form of derivative financial instruments. Its objective is to guide the Caisse's exposure to the main asset classes in a flexible manner and to calibrate the risk-return profile of the Caisse's overall portfolio.

Strategy

The goal of consolidated asset allocation activities is to actively manage the allocation of assets in the Caisse's overall portfolio over an investment horizon of less than three years. There are two types of asset allocation activities:

- Activities carried out through the use of derivatives, particularly with the aim of protecting the portfolio against the risks of extreme fluctuation, and recorded in the Asset Allocation portfolio.
- Activities tied to the overweighting and underweighting of specialized portfolios, the impact of which is recorded directly in these portfolios.

Returns

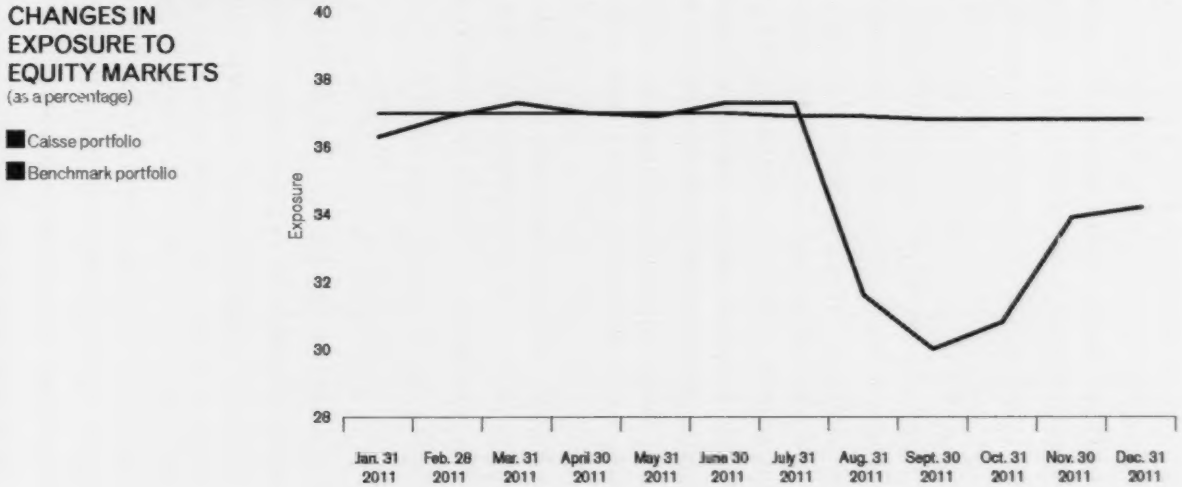
In 2011, asset allocation activities were initially carried out to neutralize cash positions. In the second half of the year, they were carried out to protect the overall portfolio (see Analysis of Overall Performance, p. 28).

As at December 31, 2011, the net investment results of the Asset Allocation portfolio amounted to $121 million (see Table 29, p. 47). This positive result is attributable, in particular, to activities intended to protect against declines in equity markets, by means of derivatives.

Figure 28 presents the changes in the Caisse's equity market exposure.

FIGURE 28

CHANGES IN EXPOSURE TO EQUITY MARKETS
(as a percentage)



ABTN

Description

The portfolio is composed of asset-backed term notes (ABTNs). These medium-term notes have an average maturity of five years and generate quarterly interest income.

Strategy

The ABTN portfolio aggregates activities that are declining. Controlling and reducing risks are therefore a key component of the portfolio management strategy. In 2010, managers put in place hedges that made it possible to reduce market exposure by close to 50%. In 2011, these hedges helped reduce portfolio volatility in a jittery market. Starting in 2012, the objective is to carry out transactions that will make it possible to close certain positions. The portfolio's activities are still expected to end in 2016-2017.

Returns

Weak economic growth, but especially fears relating to the sovereign debt crisis in the eurozone, resulted in wider rate spreads in 2011. The widening was more pronounced for the securities of financial institutions, European securities and high-yield securities than for corporate securities, U.S. securities and high-quality securities. Geographic area and systemic risk exposure were factors that caused the spreads to widen. At the close of the year, spreads were still very wide in spite of improved market conditions in the fourth quarter following the adoption of measures by the European authorities to resolve the crisis.

As at December 31, 2011, the contribution of the ABTN portfolio to net investment results totaled $93 million (see Table 29). The effect of wider rate spreads on the value of the portfolio's assets was more than offset by the revaluation of certain investments and the narrowing average maturities of the securities in the portfolio.

All in all, these results made it possible to reduce the ABTN provision from $4.1 billion to $4.0 billion.

TABLE 28

SPECIALIZED PORTFOLIO RETURNS – OTHER INVESTMENTS

(for periods ended December 31, 2011)

		1 year			4 years		
	Depositors' net assets $B	Return %	Index[1] %	Spread[2] (b.p.)	Return %	Index[1] %	Spread[2] (b.p.)
Hedge Funds	**3.3**	**0.5**	**(0.5)**	**94**	(1.1)	(1.6)	52
Asset Allocation[3]	**1.2**	**$121M**	**N/A**	**N/A**	$(1,673) M	N/A	N/A
ABTN[3,4]	**(2.5)**	**$93M**	**N/A**	**N/A**	N/A	N/A	N/A

1. The description of the indexes is presented in Table 9, p. 26.
2. Compared to the benchmark indexes.
3. Returns in dollars are cumulative and net of operating expenses and other fees.
4. The ABTN portfolio financing exceeds the fair market value of its investments and mainly accounts for the negative net assets.

Changes in Assets

HIGHLIGHTS

01 Depositors' net assets increased by $7.2 billion to stand at $159.0 billion.

02 Net investment results amounted to $5.7 billion. They relate primarily to Fixed Income and Inflation-Sensitive Investments.

03 Depositors' total net deposits amounted to $1.5 billion.

DEPOSITORS' NET ASSETS

In 2011, depositors' net assets increased by $7.2 billion, including net investment results of $5.7 billion attributable mainly to Fixed Income and Inflation-Sensitive Investments, and $1.5 billion in depositors' net deposits.

Depositors' net assets went from $120.1 billion as at December 31, 2008 to $159.0 billion as at December 31, 2011. This increase comes from the net investment results of $35.2 billion and depositors' net contributions of $3.6 billion.

TOTAL ASSETS

As at December 31, 2011, total assets amounted to $191.3 billion whereas they stood at $183.2 billion as at December 31, 2010, an increase of $8.1 billion (see Table 31, p. 49). The Caisse managed its liabilities very carefully and these remained stable compared to 2010. Liabilities, used in particular to fund real estate investment purchases, largely consist of short sales, securities sold under repurchase agreements, derivatives and financing programs issued by the Caisse's subsidiary, CDP Financial.

TABLE 30

ANALYSIS OF CHANGES IN DEPOSITORS' NET ASSETS

(for the period 2008-2011 – in billions of dollars)

	2008	2009	2010	2011	2008-2011
Depositors' net assets at the beginning	155.4	120.1	131.6	**151.7**	**155.4**
Investment income	6.1	5.0	4.8	**5.2**	**21.1**
Gains (losses) on the sale of investments	(23.2)	4.5	1.6	**(0.5)**	**(17.6)**
Unrealized increase (decrease) in value of investments	(22.4)	2.6	11.6	**1.3**	**(6.9)**
Operating expenses	(0.3)	(0.3)	(0.3)	**(0.3)**	**(1.2)**
Net investment results[1]	(39.8)	11.8	17.7	**5.7**	**(4.6)**
Depositors' net contributions	4.6	(0.3)	2.4	**1.5**	**8.2**
Depositors' net assets at end	120.1	131.6	151.7	**159.0**	**159.0**

1. Net investment results include income generated by depositors' demand deposits and term deposits.

ASSETS UNDER MANAGEMENT AND ASSETS UNDER ADMINISTRATION

The $3.0 billion decline in assets under management and assets under administration is mainly attributable to the sale of non-strategic assets in connection with refocusing the operations of Ivanhoé Cambridge. The real estate subsidiary sold a holding company with assets under management amounting to $2.0 billion as at December 31, 2010.

NET INVESTMENT RESULTS

Net investment results include investment income, reduced by operating expenses and external management fees, gains or losses on the sale of investments as well as unrealized gains or losses (see Table 31).

In 2011, the Caisse had net investment results of $5.7 billion compared to results of $17.7 billion in the preceding year (see Table 31). Although the net investment results are positive, they are down compared to last year, mainly as a result of the declines in equity markets.

The favourable results achieved in 2011 are attributable, in particular, to the general reduction in interest rates and increased demand for quality assets having a lower risk profile than equities, such as infrastructure and real estate investments.

The analysis of operating expenses and external management fees is presented on page 140.

TABLE 31

RESULTS AND CHANGES IN COMBINED NET ASSETS AND TOTAL ASSETS UNDER MANAGEMENT[1]

(for years ended December 31 – in millions of dollars)

	2011	2010
Investment income	**5,142**	4,850
Less:		
Operating expenses	**269**	257
Expenses related to repositioning of information technology and write-offs of intangible assets	**–**	34
Net investment income	**4,873**	4,559
Gains (losses) on the sale of investments	**(495)**	1,582
Total realized income	**4,378**	6,141
Unrealized increase in value of investments and liabilities related to investments	**1,368**	11,590
Net investment results	**5,746**	17,731
Depositors' net deposits	**1,477**	2,423
Increase in depositors' net assets	**7,223**	20,154
Depositors' net assets, beginning of year	**151,742**	131,588
Depositors' net assets, end of year	**158,965**	151,742
Liabilities (primarily assets financed by borrowing) and non-controlling interests	**32,323**	31,455
Total assets	**191,288**	183,197
Assets under management	**8,731**	11,417
Assets under administration	**4,159**	4,516
Assets under management and assets under administration	**12,890**	15,933
Total assets under management	**204,178**	199,130

1. See Note 3 of General Notes.

Changes in Assets

Investment income
Investment income, also called current income, primarily includes interest income, dividends and real estate property rental income.

For the year ended December 31, 2011, investment income totaled close to $5.2 billion, up slightly compared to 2010 results (see Table 31, p. 49).

Gains (losses) on the sale of investments
Losses on the sale of investments reached $0.5 billion in 2011, compared to gains of $1.6 billion in 2010. In 2011, the losses resulted from sales in the Equity asset class, reduced by gains on the sale of securities in other asset classes.

Unrealized increases (decreases) in value
For 2011, the Caisse posted a $1.3 billion unrealized increases in value on investments and liabilities related to investments (see Table 31, p. 49). Specifically, it recorded unrealized increases in value for the Fixed Income and Inflation-Sensitive Investments asset classes, offset by the Equity asset class. The returns for this asset class stem particularly from negative returns by equity market indexes in Canada, Europe, Australasia and the Far East (EAFE) as well as emerging countries. The Private Equity portfolio generated unrealized increases in value.

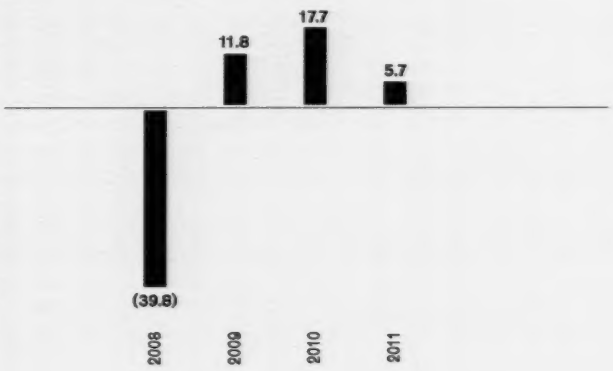
Figure 32 presents changes in net investment results from 2008 to 2011.

DEPOSITORS' NET DEPOSITS (WITHDRAWALS)

As at December 31, 2011, depositors' total net deposits of $1.5 billion are mainly attributable to contributions by the Retirement Plan Sinking Fund and the Generations Fund.

CHANGES IN NET INVESTMENT RESULTS

(for years ended December 31 – in billions of dollars)



Risk Management

HIGHLIGHTS

01 In 2011, the Caisse implemented a proactive risk management strategy in response to the debt crisis.

02 In an environment characterized by uncertainty, the Caisse actively and rigorously managed its credit, counterparty and liquidity risks.

03 Several actions were taken to continue to enhance risk management tools and methodologies.

RISK MANAGEMENT AT THE CAISSE IN 2011

Several major risks appeared in 2011 and had consequences for financial markets. The tsunami and nuclear accident in Japan as well as the Arab Spring uprising marked the beginning of the year. But it was the problems related to debt levels of developed countries that dominated the attention of investors and the Caisse in 2011. In order to tackle the 2008 financial crisis, support their financial institutions and massively stimulate their economies, governments significantly increased their financial burden, which was already heavy.

The debt crisis first made itself felt in the United States, with the political crisis between the Senate and the House of Representatives concerning the increase in the U.S. debt ceiling; it became the main source of concern and anxiety for investors. However, this political crisis was soon overtaken by the European sovereign debt crisis. These events had repercussions for market, credit and counterparty risk for the Caisse and for all investors.

Sovereign bonds from several countries, which had hitherto been considered risk-free investments, experienced a rapid and abrupt decline in value, carrying in their wake the market capitalization of several European banks and insurers that held a significant portion of the sovereign debt. Markets were very volatile, especially in the second half of the year. Between its peak on April 4 and its lowest point on October 3, the S&P 500 Index fell approximately 20%, although it later regained most of its losses and ended the year slightly up. Movement of this magnitude creates a lot of uncertainty and market dislocations.

AN EFFECTIVE RESPONSE BY THE CAISSE TO THE UNCERTAINTY REGARDING THE EUROPEAN SITUATION

In early summer 2011, after a detailed analysis of the risks affecting its portfolio, the Caisse proactively implemented a major underweight strategy in equity markets, because it judged that the risk level was high and had the potential to get worse. This strategy ensured that the Caisse's overall portfolio did not present an inappropriate level of market risk for the interests of its depositors. The scope of the hedging was moderated as a function of the estimated probability that the situation would markedly deteriorate, and on the basis of the analyses made and updated during this period. Thus, at its height, the underweighting represented close to 25% of the total amount of publicly traded shares in the portfolio. Its effect was to reduce the volatility of returns by 20%. In the fourth quarter, the Caisse gradually decreased this position, as it judged that the measures announced by the European Central Bank to ensure the liquidity of the financial system had reduced the likelihood of an extreme market correction.

This major defensive strategy was developed thanks to close collaboration between the risk and investment teams. Detailed scenarios were developed, ranging from Greece leaving the eurozone to the complete breakup of the eurozone. These scenarios were used to determine the potential losses of both the benchmark portfolio and the Caisse's investments. The results of stress tests modulated the level of risk considered to be appropriate in view of the prospective risks related to financial, economic and political events. Thus, for most of 2011, the Caisse reduced its risk level and adopted a defensive strategy to decrease the potential effects of extreme risks, while continuing its investment activities and seizing opportunities for long-term investment that emerged. This approach contributed directly to the results obtained in 2011.

Risk Management

The effects of implementing this defensive strategy could be clearly observed with the risk analysis tools developed by the Caisse over the last two years, as Figure 33 shows.

Active management of credit, counterparty and liquidity risks

In addition to the actions taken to reduce its market risk, the Caisse actively managed its credit, counterparty and liquidity risks. At the first signs that the situation in Europe could potentially worsen, it closely monitored all of the positions in its portfolio:

- Certain investments that represented a credit risk deemed inappropriate were not renewed.
- The risk represented by the positions negotiated with each counterparty as a function of market movements was analyzed in detail.
- The financial position of large counterparties that were particularly exposed to the sovereign debt crisis was monitored with help of several market indicators.
- Movements affecting collateral calls for positions in derivatives were also monitored, ensuring that no major movement affected these positions and liquidity.
- Activities with the most at-risk counterparties were reduced and certain business relations were reviewed.

CHANGES IN RISK MEASUREMENTS

Absolute and active market risk

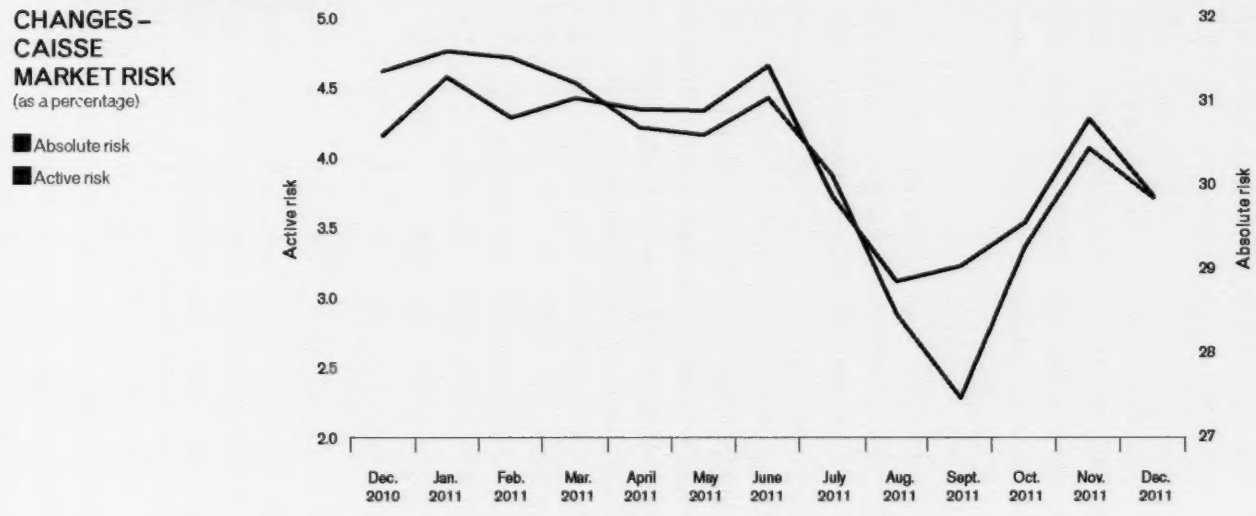
As at December 31, 2011, the market risk of the Caisse's overall portfolio was slightly lower than the level as at December 31, 2010.[1] The absolute risk declined from 31.4% at the end of 2010 to 29.9% at the end of 2011. The active risk fell from 4.2% to 3.7% during the same period (see Tables 34 and 35, page 53).

As Figure 33 shows, the market risk measurements fluctuated significantly during the year. The considerable decline in the Caisse's absolute and active market risks observed in the second half of the year is mainly attributable to the hedging transactions carried out following the sovereign debt crisis. Thus, the Caisse dynamically adjusted the market risk of its portfolio based on its assessment of prospective risks.

1. Value at Risk (VaR) is now measured on a historical sample of 1,500 days instead of 1,300 as in 2010. Since the data as at December 31, 2010, presented in this text has been recalculated with the aid of a 1,500-day historical sample, risk levels are not comparable to those presented in the 2010 Annual Report.

FIGURE 33

CHANGES – CAISSE MARKET RISK
(as a percentage)



As Figure 36 shows, the strong decline in market risk observed between July and October, followed by a rise between October and December, is almost entirely explained by the extent of the underweighting of Equity portfolios (comprising the Equity asset class with the Private Equity portfolio).

It should also be noted that, between August and October 2011, the Caisse decided to reduce its level of market risk below that of the benchmark portfolio. This kind of defensive position constitutes a first since it started measuring the market risk of its portfolio.

TABLE 34

MARKET RISK – ABSOLUTE[1]

(as a percentage of total net value of the asset class as at December 31)

Asset classes	2011	2010
Fixed Income	**10.2**	10.0
Inflation-Sensitive Investments	**41.5**	35.7
Equity	**47.0**	47.2
Other Investments[2]	**1.5**	2.2
Global	**29.9**	31.4

1. All these values are presented using the new methodology (VaR 99%, 1,500 days).
2. The risk of the Other Investments asset class is presented as a percentage of the Caisse's net assets. This asset class contains the Hedge Funds, ABTN and Asset Allocation portfolios.

TABLE 35

MARKET RISK – ACTIVE[1]

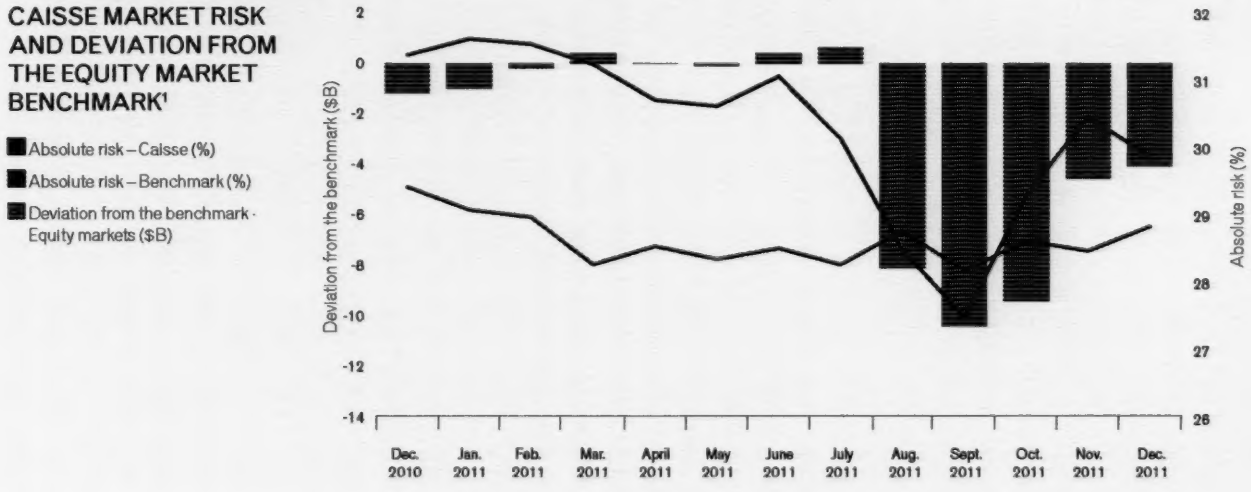
(as a percentage of total net value of the asset class as at December 31)

Asset classes	2011	2010
Fixed Income	**1.2**	1.2
Inflation-Sensitive Investments	**16.5**	10.2
Equity	**4.7**	5.7
Other Investments[2]	**1.5**	2.1
Global	**3.7**	4.2

1. All these values are presented using the new methodology (VaR 99%, 1,500 days).
2. The risk of the Other Investments asset class is presented as a percentage of the Caisse's net assets. This asset class contains the Hedge Funds, ABTN and Asset Allocation portfolios.

FIGURE 36

CAISSE MARKET RISK AND DEVIATION FROM THE EQUITY MARKET BENCHMARK[1]



1. The deviation from the benchmark includes both the spot position and derivative positions.

Risk Management

The slight drop in the absolute risk of the Caisse's overall portfolio in 2011 comes mainly from the hedging transactions on equity markets still present in the portfolio as at December 31, 2011 (Other Investments asset class) (see Figure 37). The rise in risk for the Inflation-Sensitive Investments asset class is a result of new investments and revaluations of investments, whereas the decline observed in the Equity asset class is mainly due to the decreased weighting of the Energy and Materials sectors within the Canadian Equity portfolio.

The decrease in the Caisse's overall active risk results in equal measures from the reduction in the active risk of the Equity asset class and the Other Investments asset class (see Figure 38). These drops more than offset the increase in active risk of the Inflation-Sensitive Investments asset class caused by new investments and by the revaluation of investments in the Infrastructure portfolio. The decrease in the Equity asset class results from the Private Equity portfolio, for which the allocation by business is very close to that of its benchmark index. Finally, the decline in active risk for the Other Investments asset class can be explained by the hedging transactions of the Asset Allocation portfolio, the termination of certain transactions underlying the ABTN portfolio and the approaching maturity of other transactions in that same portfolio.

FIGURE 37

MARKET RISK – ABSOLUTE[1]

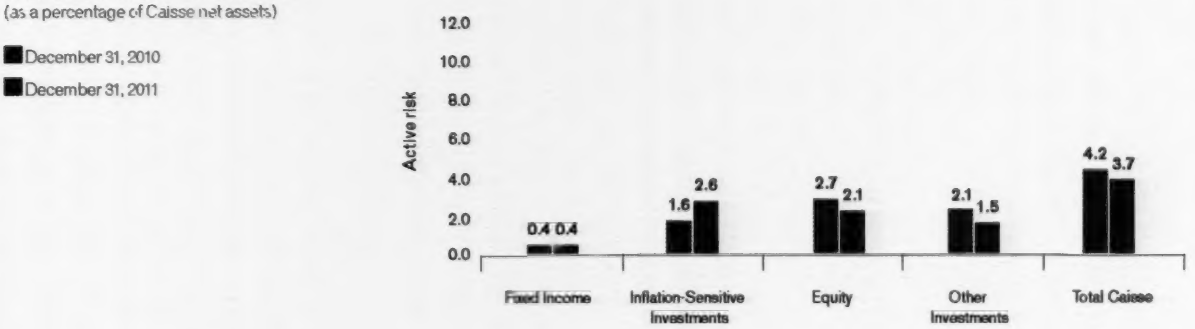
(as a percentage of Caisse net assets)

1. All these values are presented using the new methodology (VaR 99%, 1,500 days).

FIGURE 38

MARKET RISK – ACTIVE[1]

(as a percentage of Caisse net assets)



1. All these values are presented using the new methodology (VaR 99%, 1,500 days).

Credit risk

In a context in which rate spreads rose and risk-free rates fell, several actions were taken to reposition the portfolios exposed to credit risk. In particular, the Caisse used the credit VaR developed in the last two years to measure and track changes in credit risk.

In 2011, the Caisse continued to reduce its exposure to private debt investments, namely investments in the Bond portfolio with the highest credit risk level. The Caisse reduced its holdings of securities rated BB+ and lower, as well as unrated ones. It also reduced its international corporate debt exposure and its unsecured loans to financial institutions. The reduction in the Caisse's credit risk also results from the decrease in its exposure to international mortgage loans, which continued during 2011. This decrease substantially reduced the Real Estate Debt portfolio's exposure to credit risk. These decisions contributed to increasing the average credit quality of the Caisse's investments and reducing credit risk.

Counterparty risk

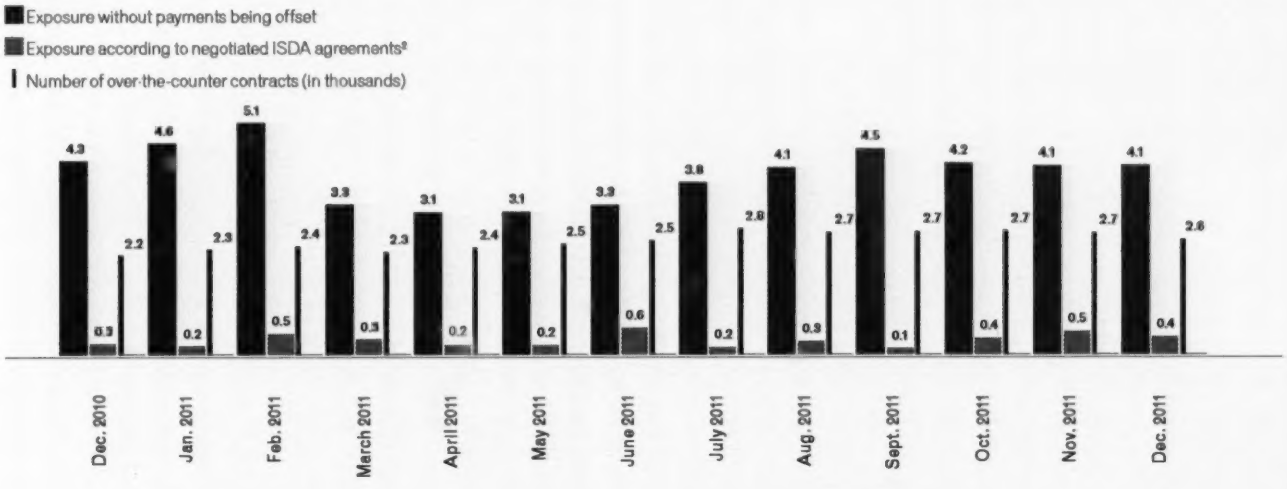
During the year, the credit risk of several counterparties with which the Caisse negotiates and engages in financial transactions was under pressure. This deterioration is mainly explicable by the European sovereign debt crisis and the weak recovery of the U.S. economy (see Figure 39).

The Caisse implemented a daily monitoring process based on a series of financial indicators for each of its counterparties. The counterparties' financial health was also reviewed periodically by a team made up of representatives from the investment teams specialized in the financial sector and from the risk teams. Thus, the Caisse was able to act rapidly in the face of deteriorating credit conditions. It kept its counterparty risk at a low level by reducing certain activities with counterparties considered to be at risk and by transferring certain transactions to sounder counterparties, while retaining a low overall net exposure to counterparty risk during the year.

FIGURE 39

CHANGES IN EXPOSURE TO COUNTERPARTY RISK[1]

(in billions of dollars)



1. This figure excludes the counterparty risk incurred directly by the real estate subsidiaries and the hedges related to ABTNs.
2. Under ISDA agreements, net exposure is gross exposure less the netting of amounts at risk and the exchange of collateral.

Risk Management

Liquidity risk
In a market context in which uncertainty and volatility remained high throughout the year, the Caisse retained a very comfortable level of liquidity.

As at December 31, 2011, the Caisse and its real estate subsidiaries possessed more than $45 billion in liquidities, which meant that the Caisse was more than able to respect its potential commitments, even in the event of a major market correction. During the year, the Caisse reduced its use of equity futures in the U.S. Equity and Québec International portfolios. As well, it added asset allocation positions, which diversified its derivatives portfolio. These measures reduced its potential commitments.

The Caisse uses different extreme scenarios to judge the adequacy of the liquidity it holds. These risk management tools were developed over the last two years.

IMPROVEMENT OF RISK MANAGEMENT METHODOLOGIES AND TOOLS

In 2011, the Caisse took several steps to continue improving its methodologies and tools as well as strengthening its oversight and processes in risk management.

Analysis of liquidity risk by portfolio
The Risk group continued to refine its monitoring of liquidity risk and is now able to issue an analysis of the sources and needs for liquidity of each of its portfolios.

Stress tests
The stress test tools developed in the last two years enabled the Risk team, in partnership with the Economic Analysis and Asset Allocation teams, to model different scenarios and quantify the impact they would have on the Caisse's overall portfolio. These tools made it easier to calibrate the hedging implemented in 2011 to protect the portfolio from the decline of equity markets.

Detailed analyses, involving various scenarios and stress tests, were completed for several major financial risks that could have a significant impact on the Caisse's results. In 2011, the analyses concerned the following prospective risks: the European debt crisis, the crisis in the Middle East, the economic slowdown in the United States and the potential economic slowdown in China.

The Caisse also developed a turbulence index that enables it to identify market conditions reflecting periods of abnormal volatility. Recent years have shown that financial markets are subject to different sets of conditions. The market dynamics (correlation between asset classes, levels of volatility) are very different in so-called "calm" and "turbulent" conditions. Classical market modeling is not very well adapted to these kinds of dynamics.

The model developed in 2011 makes it possible to systematically distinguish periods of turbulence using a new index that measures the turbulence level in one or more markets. This new measure allows the Caisse to assess the potential behaviour of its portfolio based on market conditions, better calibrate potential hedging transactions and gain a better understanding of correlation effects in the overall portfolio.

Improved quantitative risk analysis capacities
Risk measurement tools play a double role, as they are useful for control purposes and as portfolio management tools.

In 2011, several initiatives aimed to strengthen the Risk group's ability to support the investment teams. Resources are now dedicated to the quantitative analysis of risks and play an advisory role on technical questions for the investment teams. Furthermore, technology improvements allow for a better understanding of the evolution of risk levels.

Risk analysis of investment proposals
The Caisse continued to refine the risk analyses of investment proposals, emphasizing prospective risks, by the following means:

- Reviewing value creation strategies;
- Carrying out an in-depth analysis of operational, financial and valuation risks;
- Paying close attention to the critical assumptions of financial models;
- Assessing the volatility of fair value measurement parameters;
- Making an effort to standardize risk premiums as a function of business risks.

The analyses of investment risks in equity markets have been improved by the integration of new quantitative and qualitative measurements, in particular for geopolitical and reputation risks, as well as for environmental, social and governance (ESG) factors.

Geographic analysis of the sources of company revenues
During 2011, the Caisse developed methods to identify, measure and analyse the geographic concentration of the revenues generated by companies held in the Equity Market portfolios.

REVIEW OF OVERSIGHT AND PROCESSES

The Caisse continued its periodic review of its investment policies in 2011, based on modifications in its strategy or changes in markets. It also modified its oversight framework and processes, in particular for credit and operational risks.

Review of the Infrastructure portfolio's investment policy
During the year, due to market constraints, the Caisse reviewed the Infrastructure portfolio's investment policy, mainly in relation to the segmentation of the leverage level by type of infrastructure investment. The review considered the business specificities inherent in each investment category.

Review of the Global Equity portfolio's investment policy
The Caisse also reviewed the investment policy of the Global Equity portfolio. It added strategies focusing on companies for which the long-term return on investment is high, but for which the volatility is lower than that of the benchmark market.

Upgrade of credit analyses
In 2011, the Caisse adopted the principle of engaging experts in advanced analysis in order to reduce its dependency on the ratings issued by the credit agencies. This principle is based on best practices in the industry, as proposed by the Financial Stability Forum, among others. An internal rating must be established on the basis of a rigorous credit risk analysis, which meets the standards set by the Risk group. The Caisse aims to perform and review detailed credit analyses on the debt securities in its portfolio.

Implementation of a financial risk watch process
With the aim of refining the integrated risk management process, the financial risk monitoring was upgraded in 2011. This monitoring process made it possible to map the main financial risks to which the Caisse is exposed and rank the most important ones. Indicators were established by major asset class in order to better monitor developments in these risks and foster more proactive management.

Strengthening of operational risk management practices
In 2011, the Caisse made major changes in the methodology and governance of its operational risks. It set up the Operational Risks Committee (ORC), a subcommittee of the Executive Committee, chaired by the head of the Risk group. This Committee has the mandate to prioritize operational risk issues submitted by the Risk group, after consultation with the Caisse's various sectors, to approve measures to mitigate these risks and to monitor the progress of the resulting work.

Redeployment of the Risk group
The Risk group was redeployed in 2011 to increase its ability to meet the challenges raised by changes in the economic and financial environment. The major objectives of this redeployment are as follows:

- increase the effectiveness and efficiency of risk management activities;
- strengthen the capacity for qualitative and quantitative risk analysis and the level of expertise;
- provide the group with competencies that complement its chosen directions;
- foster better cooperation within the group;
- favour a client-service orientation for each investment activity.

Several changes in the organization of work and the division of labour were made, including:

- regrouping of risk measurement activities;
- creation of a unit responsible for managing risk data within the group;
- creation of quantitative analysis groups for each portfolio;
- upgrading of qualitative analysis activities, especially as regards investment products.

Risk Management

Review of derivatives in the portfolio
The Caisse reviewed and analyzed all the derivatives held in its portfolios. In the context of legislative changes around the world, it summarized the potential impacts on its portfolios of amendments to the rules in the U.S., European and Canadian jurisdictions. This analysis included the anticipated effects on the Caisse's liquidity and the implementation of new products subject to clearing houses, as well as what monitoring needs to be established. The Caisse also analyzed the improvements in its reports, risk management tools and oversight.

THE RISK-RETURN DIALOGUE

Risk management is inseparable from the investment and portfolio management processes. Since the investment teams must consciously take risks to generate the expected returns, the risk-return relationship is an integral part of their activities. In this context, robust risk management is indispensable for ensuring that our managers take and control calculated risks.

Risk management governance ensures the transparency of the Caisse's investment activities. At each meeting of the Caisse's Risk Management Committee, the following aspects of accountability include:

- review of the investments covered by the investment policies;
- analysis of a risk measurement for each portfolio linked to returns;
- analysis of the different concentrations and risk factors.

The risk-return reports, which are the core of our approach, provide an in-depth analysis of every activity, the results obtained and the assessments of the risks taken. The risk and investment teams prepare the risk-return reports in collaboration, improving their quality, simplifying them and thus facilitating their understanding by the Risk Management Committee. These reports serve to reinforce the risk-return dialogue within the Caisse.

The investment teams, economists and the Caisse's Risk team define the stress tests that must be carried out. These tests are developed by monitoring the Caisse's major prospective risks and are used to assess their impacts on the portfolio. The risk and investment teams also work together to ensure that risk limits are respected. Action plans are developed to ensure the implementation of the required adjustments, and these action plans are monitored in collaboration with the investment teams.

As a result, throughout the year, a dialogue is maintained between the investment and risk teams. The support of the Risk team for the portfolio managers along with the constructive criticism this team brings to the table are now part of the Caisse's practices, strengthening the institution's risk culture.

The risk management team is continuing to develop its approach to go "beyond measurement" in order to ensure healthy oversight of risks and to add value for the portfolio managers.

THE RISK GOVERNANCE MODEL

To ensure a risk-return balance in the performance of its second level of risk control, the Risk team's strategy is based on the following:

- Integration of risk experts working together with each of the investment teams.
- Development of effective analytical tools.
- Integration of the risk component into all of the Caisse's business processes.
- Development of a better understanding of the risks arising from the Caisse's operations.

The team has a vision of becoming a reference in the following areas:

- Analysis of investment products.
- Transversal knowledge of the full range of portfolios and interrelations existing between investment products.
- Transversal knowledge of the Caisse's business functions with a view to ensuring that proactive management of operational risks is implemented.

This strategy is consistent with the overall risk management approach adopted by the Caisse and described in its Integrated Risk Management Policy.

Integrated Risk Management Policy
The Caisse adopted a global and centralized approach for risk management oversight: the Integrated Risk Management Policy (IRMP).

This policy is reviewed regularly and is aimed at fostering a disciplined risk management culture and practices. More specifically, the IRMP defines risk management governance, sets the level of risk deemed acceptable to prevent excessive losses, aligns this level of risk with value-added objectives and aims to allocate risk effectively.

The IRMP is the cornerstone of risk oversight. It includes reporting mechanisms and describes different aspects of risk management, particularly:

- the guiding principles, namely the risk model and the independence of the support teams in integrated risk management;
- the organizational structure, the normative framework, governance and sharing of responsibilities;
- risk budgets;
- limits on authorization of transactions and on authorization of management outsourcing and concentration limits per issuer;
- a framework for management outsourcing and the use of financial derivatives;
- the management of different types of risk.

Levels of control in risk management
Risk management is ultimately the responsibility of the Board of Directors. However, managers at all levels are required to integrate risk management into daily decision-making process. It applies to all Caisse employees and agents in the fulfillment of their duties.

Governance of risk management is based on three levels of control:

Level 1 – The portfolio managers, who are primarily responsible for managing risks related to operations under their purview.

Level 2 – The Risks Committee (RC) a subcommittee of the Executive Committee, assisted by the Risk group and the Policies and Compliance group. The Operational Risk Committee (ORC), a subcommittee of the Executive Committee, assisted by the Risk group.

Level 3 – The Board of Directors and its Risk Management and Audit Committees – in addition to the Internal Audit division.

In order to ensure the necessary objectivity and rigour, teams independent of those in investments are responsible for defining and overseeing the IRMP and the investment policies of the specialized portfolios, while monitoring their application.

Investment policies and risk budgets
Investment policies are intended to define the framework for the work of portfolio managers. Each specialized portfolio is associated with an investment policy that defines the investment philosophy, management style, investment universe, benchmark index, value-added objective and risk oversight, including concentration and risk limits.

A risk limit, or risk budget, is set for each specialized portfolio and the Caisse's overall portfolio. This risk budget takes into account each portfolio's value-added objectives. For the Caisse's overall portfolio, the risk limit also reflects the diversification effect of the specialized portfolios.

Risk Management

RISK MODEL

At the Caisse, the risk model is the basis for identifying, assessing and managing risks. It establishes a common language to ensure the various stakeholders can communicate effectively about risk management. The risk model also fosters rigorous and exhaustive analysis of each risk. Ultimately, this process leads to the implementation of investment strategies that generate stable and sustained returns to meet the depositors' expectations.

Within this model, the risks inherent in the Caisse's activities are divided into three broad categories: business, financial and operational risks (see Figure 40). Each category consists of sub-categories for accurately identifying all possible risks. Each risk requires a specific management approach.

FIGURE 40

THE CAISSE'S RISK MODEL

Business risks

Strategic risk

Strategic risk represents the possibility that an event related to the practices or relationships of the Caisse, its subsidiaries or employees, will contravene its mission, its culture and its fundamental values.

Strategic risk is also related to the inadequacy of business strategies and deficiencies in the implementation of the Caisse's strategic direction. The Caisse will indeed be exposed to strategic risk if its resources are not allocated according to the set priorities.

The Caisse manages this risk using a structured strategic planning process that involves all of its sectors. Strategic direction is proposed by the Executive Committee, approved by the Board of Directors and communicated to all employees. Annual business plans are subsequently drawn up. The members of the Board of Directors and the Executive Committee receive a quarterly summary of the Caisse's activities.

Reputation risk

Reputation risk represents the possibility that an event related to the business practices or relationships of the Caisse, its subsidiaries or its employees, will adversely affect the Caisse's image or cause the public to lose confidence in the institution. This risk could detract from the Caisse's ability to achieve its objectives.

All directors, members of senior management and employees are responsible for carrying out their activities so as to minimize reputation risk.

The Caisse manages and controls this risk through codes of ethics and professional conduct for members of senior management, directors and employees, training programs, effective internal management and governance practices and a set of policies and procedures, including its Policy on Responsible Investment. The Caisse also ensures that the information it provides internally and externally is truthful and has been previously validated, and aims to ensure that the public and the media gain a better understanding of its operations. The Caisse also monitors relevant communications reports and issues public positions, whenever necessary.

Financial risks

Market risk

Market risk represents the risk of financial loss arising from changes in the value of financial instruments. The value of a financial instrument may be affected by changes in certain market variables, particularly interest rates, foreign exchange rates, share prices and commodity prices. The risk arises from the volatility in prices of financial instruments, which, in turn, result from the volatility of such market variables.

The Caisse manages all market risks in an integrated manner. The main elements that give rise to risks such as industry, country and issuer, are taken into account. To manage market risk, the Caisse may use derivative financial instruments that are traded on exchanges or directly with banks and securities dealers.

Value at risk

The Caisse measures market risk using a statistical technique known as value at risk (VaR). This technique, used by most investment firms and financial institutions, covers all the assets held by the Caisse. The Caisse determines the VaR for each instrument in its specialized portfolios and aggregates the information for the overall portfolio. Two types of risk are assessed, namely the absolute VaR of the Caisse's benchmark portfolio and overall portfolio, and the VaR of active management.

VaR is based on the statistical measurement of volatility of the market value of each portfolio position and their correlations. VaR uses historical data to estimate the loss expected during a given period based on a predetermined confidence level. For example, using a 99% confidence level, the VaR indicates that a loss will exceed this level in only 1% of cases.

One of the advantages of VaR is that it includes the risk of a wide range of investments in a single measurement, providing an overall risk measurement for a portfolio and even for a set of portfolios.

The Caisse uses the historical simulation approach to assess VaR. This method is based primarily on the assumption that the fluctuation of securities in a given period infers future fluctuation of securities. This method requires that the series of historical data for all the risk factors necessary to assess the returns on instruments be available. In the absence of such historical data, particularly for less liquid products, such as private equity and real estate, substitute securities and various mathematical models are used to calculate VaR. Historical data from 1,500 days of observation of risk factors such as variations in exchange rates, interest rates and financial asset prices, are used to assess the volatility of returns and the correlation between returns of various assets.

The results of the calculations obtained by applying this methodology do not allow the inference of an estimate based on a specific event, of the amount of the loss that a portfolio would incur if such an event recurred.

The methodology used by the Caisse estimates a portfolio's risk by annualizing its potential daily loss, that is, by assuming that the amounts lost throughout the year will be reinvested to maintain the same level of risk. In summary, this methodology means that the effects of the worst adverse events on the portfolio observed over a one-day horizon will be repeated several times a year.

It is inappropriate to make a connection between the calculation of VaR at 99% used by the Caisse and a specific historical event. This methodology is not intended for this objective. It seeks to provide the Caisse's managers with the means to assess and manage portfolio risk dynamically.

VaR measures risk under normal market conditions. Therefore, losses realized may greatly differ from the VaR when the historically observed interrelationship between risk factors is disrupted.

As VaR is not designed to be used on its own, the Caisse uses complementary limits and measurements. In particular, specialized portfolio investment policies are used to define concentration limits (geographic, sector, instrument type, issuer, etc.) as well as loss limits.

Risk Management

Absolute risk and active risk

Any investment decision involves an element of risk, including the risk of a gain or loss arising from a fluctuation in the value of financial instruments held in a portfolio. The same method is used to calculate the absolute risk of the Caisse's benchmark portfolio and overall portfolio.

The absolute risk of the benchmark portfolio represents the result of the risk of the benchmark indexes related to the asset classes that make up the portfolio at a given date. For example, if the depositors choose to increase the bond weighting and reduce the weighting of publicly traded equities in their respective benchmark portfolios, the risk will automatically decrease, given the lower volatility of bonds. Consequently, the expected long-term absolute return will also decrease.

The absolute risk of the overall portfolio is the result of the risk of the positions that make up the Caisse's overall portfolio at a given date.

Active risk represents the possibility that the Caisse's return will diverge from the benchmark portfolio return due to active management of its portfolio. The greater the active risk, the more the overall portfolio's expected absolute return (see Figure 41) will diverge from the benchmark portfolio return.

The absolute risk of the Caisse's benchmark portfolio and the active risk and the absolute risk of the overall portfolio are measured regularly and are subject to various limits.

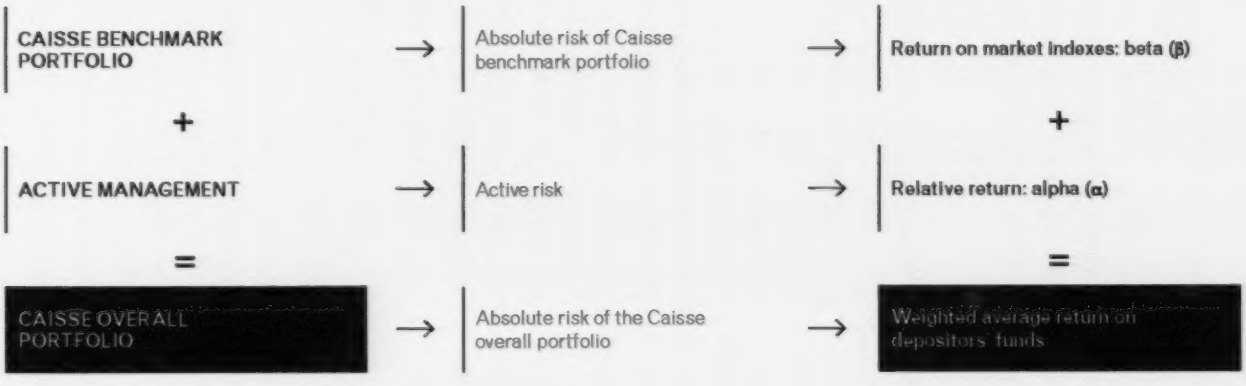
Stress tests

The Caisse also uses stress tests to assess the losses of a specialized portfolio and the Caisse's overall portfolio in extreme circumstances. The stress test is a risk measurement that complements VaR by estimating the impact of extreme circumstances on returns. These circumstances have a low probability of occurring but are likely to give rise to substantial losses. Using different types of extreme scenarios, the stress test measures the loss of value of a position following a variation in one or more usually interrelated risk factors such as equity prices, interest rates, rate spreads, foreign exchange rates, commodity prices and market volatility.

Like VaR, the stress test includes the risk of many positions in a single overall measurement, making it possible to analyze losses for a portfolio or for a set of portfolios, under selected extreme scenarios.

FIGURE 41

COMPONENTS OF THE CAISSE'S RISK AND RETURN



Credit, concentration and counterparty risk

Credit risk

Credit risk represents the possibility of a loss of market value in the event a borrower, an endorser, a guarantor or a counterparty does not honour its obligation to repay a loan or fulfill any other financial obligation, or experiences a deterioration of its financial position.

Credit risk analysis involves measuring the probability of default and the recovery rate on debt securities held by the Caisse and monitoring changes in credit quality of issuers and groups of issuers[1] whose securities are held in all of the Caisse's portfolios. In managing credit risk, the Caisse frequently monitors changes in the ratings issued by rating agencies and compares them with in-house credit ratings, whenever available. It also uses the credit VaR for its Bond, Long Term Bond, Real Return Bond and Real Estate Debt portfolios.

Credit VaR is a statistical measurement that integrates the information on the current and potential creditworthiness of issuers in the portfolio, their interrelations and the level of loss in case of default. This measurement therefore allows potential losses to be assessed over a period based on a specified confidence level. The Caisse assesses the credit VaR over a one-year period at a 99% confidence level.

Concentration risk

Concentration risk analysis measures the fair value of all the financial products related to a single issuer or group of issuers[1] with similar characteristics (geographical area, industry, credit rating).

The concentration limit by group of issuers[1] is set at 3% of the Caisse's total assets. Securities issued by the Government of Canada, the Government of Québec or any other Canadian province or territory or by their ministries or departments and agencies are exempt from this calculation as they are not subject to concentration limits. Sovereign issuers with AAA credit ratings are also excluded from this concentration limit. Lastly, specific concentration limits apply to investments in emerging markets.

Counterparty risk

Counterparty risk represents the credit risk from current or potential exposure to over-the-counter financial instruments resulting from the Caisse's operations.

Transactions involving derivatives are carried out with financial institutions whose credit rating is established by recognized rating agencies and for which operational limits are set by senior management. Moreover, the Caisse enters into legal agreements based on the standards of the International Swaps and Derivatives Association (ISDA)[2] to benefit from the netting of amounts at risk and the exchange of collateral to ensure the Caisse limits its net exposure to this credit risk.

Current exposure to counterparty risk is measured daily, as per the legal agreement in effect. Potential exposure to counterparty risk is measured monthly.

Liquidity risk

Liquidity risk represents the possibility that the Caisse may not always be able to fulfill its commitments related to its financial liabilities without having to obtain funds at abnormally high costs or proceed with a forced sale of assets. It also corresponds to the risk that it may not be possible to sell investments rapidly or to invest without having a significant adverse effect on the price of the investment in question.

Compliance with preset rules is reviewed every month, in addition to the daily monitoring of liquidity. The Caisse simulates various scenarios to assess the potential impact of different market events on its liquidity position. The managers responsible assess the liquidity of the markets on which the Caisse's financing operations are based. They also ensure the Caisse is active in different financial markets and maintains relationships with credit rating agencies that rate the Caisse as well as providers of capital.

1. A group of issuers is controlled by a parent company.
2. ISDA promotes sound risk management practices and issues legal opinions on netting and collateral arrangements.

Risk Management

Operational risks
Operational risk corresponds to the possibility of direct or indirect financial loss resulting from deficiencies within the operations.

Operational risk management and assessment require risks to be self-assessed, incidents to be listed, indicators to be used and rigorous processes to be maintained.

Human resources management risk
The risk related to human resources management includes such elements as recruiting and retention (recruiting and retaining competent, honest and motivated personnel), training (maintaining and developing employee competencies) and evaluating performance and compensation (ensuring fair, equitable and competitive compensation based on performance).

Process management risk
The risk arising from process management is related to the processes for input, settlement and tracking of transactions, and errors that may arise in the execution of the processes in place. In addition to internal causes, this risk may arise from the poor quality of services rendered by subcontractors, suppliers and business partners.

System management risk
The Caisse is exposed to a risk in the event of deficiency of its information technology infrastructures or computer systems. This deficiency may result from a breakdown or other malfunction that may cause delays or an interruption in operations that is not caused by a disaster.

Theft and fraud risk
This is the risk of losses arising from intentional acts to defraud, to embezzle funds or to appropriate the assets of the Caisse or of its depositors.

Disaster risk
Disaster risk represents the risk of losses resulting from the interruption of business following a natural or other disaster.

Compliance risk
Compliance risk corresponds to the risk of loss resulting from non-compliance with regulatory obligations, with policies and directives, or with professional and ethical standards and practices specific to the Caisse's operations. It occurs in the event that the Caisse fails to fulfill its duties.

Legal risk
Legal risk is related to the rights and obligations associated with the Caisse's operations and the legislative framework under which they are carried out. Important aspects of legal risk are related to compliance with laws and regulations to which the Caisse and its management teams are subject. They also depend on the assurance that the agreements entered into by the Caisse accurately reflect the planned transactions and contain the appropriate provisions. Legal risk also refers to the risk of lawsuits that may affect the Caisse.

Compliance

HIGHLIGHTS

01 Provided depositors with semi-annual certification of compliance with depositors' and specialized portfolio investment policies.

02 Appointed a person responsible for the Language Policy and set up a language committee, in accordance with the new government policy.

03 Updated the Code of Ethics and Professional Conduct for Officers and Employees.

Compliance activities include oversight to ensure compliance with depositors' and specialized portfolio investment policies, the Code of Ethics and Professional Conduct, the Language Policy, as well as access to information, based on the Information Disclosure Policy.

DEPOSITORS' AND SPECIALIZED PORTFOLIO INVESTMENT POLICIES

An essential part of the compliance program consists in certifying compliance with the depositors' investment policies and the specialized portfolio investment policies. In 2011, certificates of compliance with these policies were delivered to depositors twice, on June 30 and December 31. Moreover, depositors were also provided with new quarterly reports to help them monitor compliance.

Deployment of the Sentinel compliance tool continued in 2011. This tool, which was already operational in all liquid market investment activities, was also deployed for the Real Estate portfolio during the year. The next phases in the implementation of this tool will continue in 2012, in particular for the Private Equity portfolio.

CODE OF ETHICS AND PROFESSIONAL CONDUCT

The compliance officers ensure that Caisse officers and employees comply with the Code of Ethics and Professional Conduct, which emphasizes the importance of adopting appropriate behaviour, taking into account the organization's practices, respect for individuals and groups, and compliance with the laws, policies and regulations applicable to the Caisse. A process in place ensures that all employees annually reconfirm their compliance with the Code of Ethics and Professional Conduct. Furthermore, all employees must report any situation that reasonably appears to represent a breach of the Code.

The Code also includes a pre-approval process for personal employee transactions. Executive Committee members must either place the management of their portfolio in a blind trust or use a passive investment vehicle for corporate securities.

At the end of 2011, the Caisse updated the Code of Ethics and Professional Conduct following a benchmarking exercise carried out with its peers.

The Code may be consulted on the Caisse's website (www.lacaisse.com), under the Governance tab.

Compliance

INFORMATION ACCESS

The Caisse adopted an information disclosure policy in which it particularly addresses its obligations with regard to access to information.

It handles requests for access to documents under the Act respecting access to documents held by public bodies and the protection of personal information (Access Act). During 2011, the Caisse processed 28 document access requests within the legally prescribed period. Out of these 28 requests, 23 were accepted, 4 were accepted in part and 1 was refused. None of the requests was subject to an application for review by the Commission d'accès à l'information.

These requests were mainly for documents concerning fees paid to professional firms, incentive compensation and benefits received by members of senior management, and costs related to sponsorships, travel, training and telecommunications.

In the case where a denial was sent involved a request for personal information and documents containing financial information, on investment management or on fund management.

LANGUAGE POLICY

The Caisse complies with the requirements of the Charter of the French language and with its Language Policy, which stipulates that French must have priority in the conduct of its operations. It attaches paramount importance to the quality and use of French in its oral and written communications. For this reason, it provides its employees with tools that support the correct use of French, as well as a variety of reference works, including a lexicon that it developed on the terminology related to its own activities. In 2011, a series of language-related items were published regularly in the employee newsletter on the appropriate use of certain expressions and idioms. In these items, the Caisse also encourages its employees to make use of the tools and references available on the Office québécois de la langue française website.

Further to the adoption of a new government policy on the use and quality of French within the public service, the Caisse reviewed its Language Policy to align it with the government's guidelines. It made the Executive Vice-President, Legal Affairs and Secretariat responsible for the application of the Language Policy. In developing and implementing the Caisse's Language Policy, she is supported by a standing committee made up of key people from within the organization.

COMPLAINT MANAGEMENT

The Caisse appointed Ginette Depelteau, Senior Vice-President, Policies and Compliance, to receive, analyze and duly handle complaints.

All complaints can be forwarded to her by phone (514-847-5901), fax (514-847-5445) or e-mail (complaintmanagement@lacaisse.com).